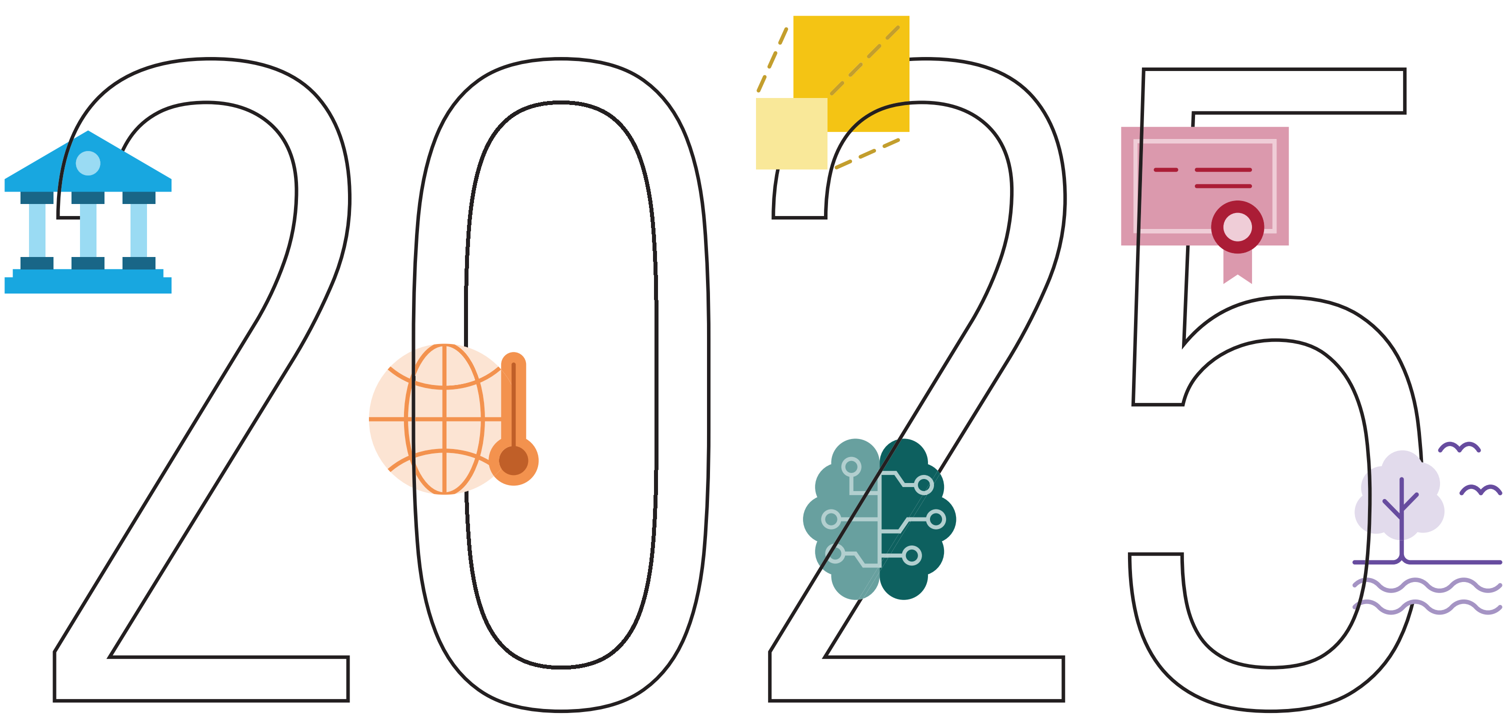
MORNINGSTAR | SUSTAINALYTICS

# Six Sustainable Investing Trends to Watch in 2025



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# Introduction

As we wind down the year and look ahead to 2025, we have chosen six themes that we think will be at the top of sustainability-aware investors' lists.

We expect sustainable investing to reveal increasing regional differences that investors will need to navigate.

Investors should welcome the first wave of standardized corporate reporting under the Corporate Sustainability Reporting Directive (CSRD) in the European Union and the adoption of International Sustainability Standards Board (ISSB) standards in other parts of the world. These regulations aim to provide more consistent, comparable, and reliable ESG data, offering better insights for investors and advancing global sustainability goals.

However, amid these positive advancements, there will be challenges. In the US, we expect the new Trump administration to roll back ESG initiatives, posing challenges for the low-carbon transition and sustainable investments. In Europe, corporates and politicians are putting pressure on regulators to demonstrate the value and efficacy of ESG policies.

In addition to discussing the key developments in ESG regulations, this report delves into how anti-greenwashing rules will reshape the ESG fund landscape, especially in Europe.

Similar to 2024, one major theme for 2025 will be transition investing. We expect investors to take a more hands-on approach to it, moving beyond simply encouraging companies to set targets to ensuring they take tangible actions. Investors will also increasingly look at the significant opportunities arising from the energy transition.

This report also examines the outlook for the green, social, sustainable, and sustainability-linked bonds (GSS+) market, which is set to resume growth in 2025, supported by a more favorable interest rate environment and investor demand for sustainable investments. GSS+ bonds have become popular debt instruments to finance the transition.

We expect to also see continued interest in biodiversity in the year ahead, with a need to scale nature finance. The rise of innovative financial mechanisms signals growing investor appetite for nature-related investments, but key challenges remain.

Finally, the report explores the ethics of Artificial Intelligence, addressing both the potential benefits and risks associated with its rapid adoption.

**Hortense Bioy, Head of Sustainable Investing Research**

# A testing year for ESG regulations

## Simplification of EU rules is a double-edged sword for ESG investors, while the ESG backlash in the US boosts prospects for greenhushing.

In recent years, policymakers across the world have been intensifying efforts to establish a standardized reporting framework, responding to growing demand from investors, stakeholders, and the public in general for credible sustainability data. These policies, culminating with the International Sustainability Standards Board (ISSB) standards at a global level and the Corporate Sustainability Reporting Directive (CSRD) in the EU, are expected to take concrete shape in 2025, enabling more consistent, comparable, and reliable ESG reporting.

At the same time, we foresee policymakers beginning to revise or, in some cases, reverse certain provisions as shifting global geopolitical dynamics and election outcomes in the EU and the US redirect political priorities from sustainability to growth, competitiveness, and security.

While the validation and implementation of these changes may take time, we think their mere announcement could weaken the quality and availability of ESG information, frustrating ESG investors seeking to source data directly from investee companies. And while the push for regulatory simplification also presents an opportunity for investors to refine their sustainable product frameworks and better support transition strategies, changing the goalposts too frequently can be confusing and costly for investors.

ESG regulations bring significant progress but are not without challenges. While these frameworks promise better insights for investors and advance global sustainability goals, issues such as fragmentation, compliance costs and risks of greenwashing persist. The year ahead will test adaptability and meaningful impact beyond mere compliance.

### The EU faces pressure to demonstrate the value of its ESG policies

We expect 2025 to be a critical juncture for the EU's credibility, particularly with the forthcoming results of the Sustainable Finance Disclosure Regulation (SFDR) review and the first wave of CSRD reporting (see details on CSRD in the next section).

In addition to the CSRD kick-off, entities subject to the EU Taxonomy Regulation will be required to report on the alignment of their economic activities with all six environmental objectives delineated in the regulation.

These developments aim to enhance transparency and accountability within the corporate sector and, over time, foster a more sustainable investment ecosystem, aligning financial flows and capital allocation with broader environmental and societal goals.

But in light of the recent backlash against ESG initiatives and the election of Donald Trump, the EU faces mounting pressure from corporates and politicians to demonstrate the value and efficacy of its ESG policies, which have yet to yield the anticipated outcomes. This new political context has magnified the assessment by Mario Draghi, in Report on the Future of the European Competitiveness, which highlights concerns that the EU's sustainability reporting and due diligence frameworks constitute a substantial burden on companies and the financial sector, exacerbated by insufficient guidance and ambiguity in its interaction with other legislative acts. High compliance costs, difficulties in obtaining accurate data (especially for scope 3 emissions), and the risk of superficial or "box-ticking" disclosures aggravate the burden.

In response to these challenges, we anticipate that the EU will further refine existing frameworks and prioritize usability and support for entities navigating the transition to a low carbon economy, as the goal for Europe remains to be the first carbon neutral continent by 2050. The first manifestation of this new political agenda is the EU's deforestation regulation, which was originally set for December 2024, but is now proposed to take effect in December 2025, requiring companies to ensure that commodities such as soya, beef, and cocoa are not linked to deforestation. More recently, the president of the European Commission has announced a potential consolidation and simplification of three key regulations (CSRD, Taxonomy and CSDDD) via a so-called omnibus law, to lower compliance costs. Finally, the European Commission is considering whether to task the European Securities and Markets Authority (ESMA) with refining its naming guidelines for ESG funds, in order to prevent the unnecessary exclusion of companies contributing to the defense sector.

### The US faces regulatory rollback

In 2025, the Trump administration is widely expected to reverse several structural sustainability policies. For example, Trump is likely to exit the Paris Agreement again, Congress may reduce or eliminate some of the clean energy subsidies in the Inflation Reduction Act (IRA), and the Securities and Exchange Commission may reverse the rules requiring public companies to disclose greenhouse gas emissions and climate-related risks. Yet, California and several other states are set to move forward with their own climate regulations, serving as a potential backstop, though they are subject to ongoing litigation.

Meanwhile, the US Department of Labor's guidance on ESG factors for ERISA-covered plans, which has shifted when there are changes in administrations, is likely to shift back toward stricter rules requiring fiduciaries to prioritize financial returns and avoid ESG-related costs unless they are clearly linked to long-term value creation.

We think that the rollback of ESG initiatives and a continued anti-ESG sentiment could lead to further "greenhushing" – where companies downplay their environmental initiatives – and potentially hinder sustainability investments in the US.

### The rest of the world focuses on adopting ISSB standards

In the rest of the world, and despite the context in the US, the focus is likely to remain on rolling out climate and sustainability disclosures. In the United Kingdom, these disclosures will be enhanced through mandatory adoption of ISSB standards, moving beyond the current TCFD-aligned framework. Australia has effectively voted to mandate disclosures in 2025, and many other significant jurisdictions are targeting 2026 as an effective date, including major APAC investment hubs, Hong Kong and Singapore. In total, 30 jurisdictions, representing more than half of global GDP and GHG emissions, are making progress towards introducing ISSB standards in their legal or regulatory frameworks.

In parallel, several jurisdictions are due to launch or expand voluntary taxonomies (e.g. Australia, Brazil, Canada, Colombia, Hong Kong, Mexico, New Zealand, Singapore and South Korea). While these initiatives may benefit market participants that are primarily focused on local sectors, their voluntary nature and region-specific characteristics hinder scalability across asset classes and jurisdictions. This lack of scalability limits their usefulness for global investors, who are seeking a unified sustainability framework and growing increasingly concerned about the fragmentation of ESG markets.

### CSRD: What to expect from the first year of reporting

CSRD aims to standardize sustainability reporting by requiring companies doing business in the EU to disclose both the financial risks and opportunities arising from sustainability issues and their impacts on the environment and society. Companies will have to report quantitative and qualitative information according to the European Sustainability Reporting Standards (ESRS), a set of 12 thematic standards that cover a range of sustainability issues, such as greenhouse gas emissions, water use, waste management, employee diversity, working conditions and human rights. In total, up to 50,000[1] companies fall within the scope of the regulation and will need to provide disclosures in a phased manner over the next four years.

**Key insights on corporate sustainability and ISSB adoption**

| | |
|---|---|
| 82% | Of companies disclosed information in line with at least one of the 11 TCFD recommended disclosures |
| 2–3% | Of companies reported in line with all 11 TCFD recommended disclosures |
| 1,000+ | Companies referenced the ISSB in their reports |
| 30 | Jurisdictions are on the journey to introducing ISSB Standards in their legal or regulatory frameworks |

Source: IFRS Foundation. Progress on Corporate Climate-related Disclosures – 2024 Report

With an expected 11,000 entities, including some non-EU firms, starting to align their sustainability reporting with the CSRD requirements in 2025, investors are hoping to see a paradigm shift in transparency, comparability, and accountability. Morningstar Sustainalytics' early assessments suggest that companies will need time to adapt to the stringent standards, and investors will probably have to deal with variances in the quality of disclosures and data for a couple of years.

We expect discrepancies to stem from the interpretation of key concepts, such as the double materiality principle, which requires companies to consider both the financial materiality of ESG factors and their broader impacts on society. The focus on double materiality is not a new practice for large companies already conducting assessments under the Non-Financial Reporting Directive; however, these assessments do not yet match the scope and detail required by the ESRS.

We also anticipate an imbalance in the information, with climate risk disclosures taking precedence over other environmental and social topics due to the phased rollout and the learning curve. Moreover, probably only a minority of companies – the most advanced – will be able to explain the effects of their material risks and impacts on their business model, strategy and decision-making.

Pragmatism will prevail as companies have expressed concerns over the cost of the reporting exercise and the potential trade-off between the time spent on reporting and the time invested in actual sustainability initiatives.

Over time, the first reports and later the adoption of sector-specific standards, set for 2026, are expected to improve the comparability of ESG information, ultimately benefiting investors and enhancing decision-making.

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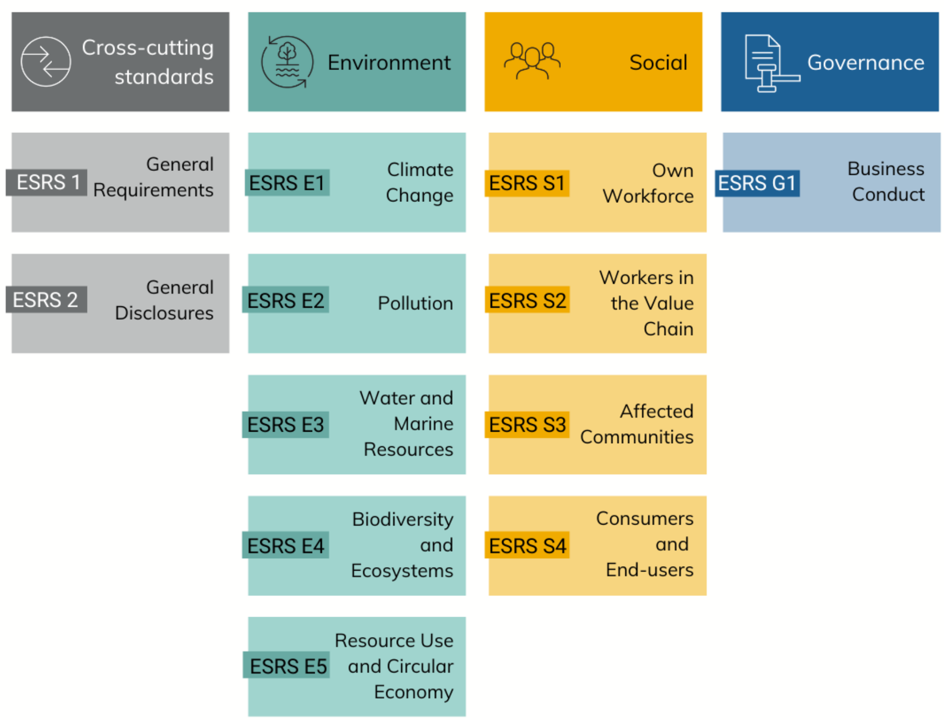
**Overview of the European Sustainability Reporting Standards (ESRS)**




Source: European Sustainability Reporting Standards.

[1] Criteria

# Transition investing: From targets to tangible action

We expect investors to take a more hands-on approach to the low-carbon transition in 2025, moving beyond simply encouraging companies to set targets to ensuring tangible actions are taken.

It is widely acknowledged that solving the climate crisis requires much more than investing solely in green companies. Many industries are still heavily reliant on polluting practices and need to shift towards becoming sustainable. Transition plans aim to facilitate these companies' shift and signal to investors and lenders their readiness to manage climate-related risks, seize climate-related opportunities, and contribute to broader societal goals.

### Closer scrutiny of transition plans

Investors will increasingly rely on frameworks such as the EU Corporate Sustainability Reporting Directive (CSRD)[1] and the Transition Plan Taskforce (TPT) framework, now integrated into the ISSB standards, as well as the IIGCC's Net Zero Investment framework, to guide their assessments. Transition plan disclosure, currently made mandatory in the EU and the UK for large companies, will enhance transparency and comparability in companies' reporting. If it follows the trend of other frameworks, we expect the TPT to be incorporated into mandatory and voluntary disclosure regulations within a couple of years.

With global climate regulation evolving from requiring emissions disclosures to requesting transition plans, companies can expect closer scrutiny based on their ability to implement decarbonization strategies that align with their climate goals.

> According to Morningstar's latest survey, asset owners view the transition to net zero emissions as the environmental factor most material to their decision-making (55%), up from 52% in 2023.

### Setting science-based targets is good, but not sufficient

Today, over 6,600 companies across regions and industries have set emission reduction targets grounded in climate science through the Science-Based Targets Initiative (SBTi), an organization and framework increasingly used by investors and financial institutions for decision-making. But setting science-based targets is only the first step towards decarbonization and is not sufficient. In fact, based on Sustainalytics' Low Carbon Transition Rating assessment, of the 1,833 companies under our coverage that have set SBTi targets, we find that only about half have strong transition risk management practices, while the rest are not taking enough action to reach their targets. To improve the credibility of their transition plans, companies with average or weak management scores would need to, for example, strengthen their governance structures, link board and executive pay to emission reduction targets, integrate carbon pricing, set out a long-term sustainable finance strategy, adopt green technology, and engage with suppliers to set GHG reduction targets.

[1] Under the European Sustainability Reporting Standards (ESRS E1), companies must disclose their targets and explain how they are compatible with the 1.5°C target set by the Paris Agreement, and describe the decarbonization levers, such as operational and product adjustments, that support emission reduction. They are also required to disclose investments and funding supporting these plans, including EU Taxonomy-aligned capex.

### Climate adaptation and resilience: A theme gaining in prominence

Starting in 2025, in addition to transition risk, investors will increasingly focus on physical climate risk, as the effects of climate change become more noticeable. In recent years, there has been an increase in extreme weather events worldwide (such as floods, hurricanes, and droughts), a rise in global temperatures (2024 was the hottest year on record), and an increase in spending on disaster recovery. As the impact of climate change worsens, investors need to look beyond physical climate risk analysis to assess companies' adaptation and resilience efforts.

For example, a utilities company operating in wildfire-prone California could invest in burying its power lines underground to mitigate wildfire risks, a manufacturing business could start relocating facilities away from flood-prone areas, while others could invest in technologies to mitigate environmental impacts. Action on adaptation is still at an early stage for most companies and requires significant investment. But companies that proactively invest in resilience-building measures should be better positioned to weather the impacts of climate change and limit potential future losses.

As more businesses start to prepare for, adapt to and withstand climate hazards, demand for products and solutions that help adapt and build climate resilience will increase. This, in turn, will benefit companies offering such products and create investment opportunities for investors.

### Investors will continue to prioritize engagement

With transition and adaptation rising on the sustainability agenda, many investors will prioritize engagement in 2025 and beyond, rather than exclusion, as their own transition requirements loom (CSDDD).[2] Rather than simply divesting from high-carbon companies, especially those in hard-to-abate sectors, or those with high exposure to physical climate risks, investors will engage with these companies to ensure they are taking the right actions. This move reflects a deeper commitment to driving sustainable change within companies.

To fulfill their net zero objectives, investors will also increasingly look at transition investment opportunities, starting with the energy transition funding gap. According to the International Energy Agency (IEA), more than USD6 trillion will be needed per year until 2030 to achieve a successful energy transition, in addition to restricting global warming to 1.5 degrees C above pre-industrial levels.

### Investing in the energy transition

Since 2021, the green solutions sector, including wind, solar, battery, and electrical vehicles, has struggled to generate good returns for investors investing in public markets, mainly due to high interest rates and inflation in the price of raw materials. However, in 2025, with central banks expected to cut interest rates and companies becoming more efficient, project economics should improve.

Despite the uncertainties introduced by the incoming Trump administration's plans to cut tax credits for green projects in the US and impose higher tariffs on Chinese imports, we think the outlook for low-carbon solutions is positive. History has shown that the energy transition will continue regardless of who is in the White House. Structural drivers, including technological advancements, cost declines, the rising demand for power (particularly coming from the growth in AI-fueled data centers), position green solutions, in both public and private markets, favorably despite near-term uncertainty.

Meanwhile, we expect companies operating in the electrical equipment sector to continue to benefit from the rising demand for green infrastructure and building efficiency, supported by robust fundamentals.

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[2] www.sustainalytics.com/esg-research/resource/investors-esg-blog/the-corporate-sustainability-due-diligence-directive--a-step-towards-stronger-human-rights-and-environmental-practice

# Sustainable bonds: Lower interest rates will bolster issuance

Lower interest rates will bolster sustainable bond issuance. We will see the birth of the EU Green Bond market. An increasing focus on transition plans brings hope for sustainability-linked bonds.

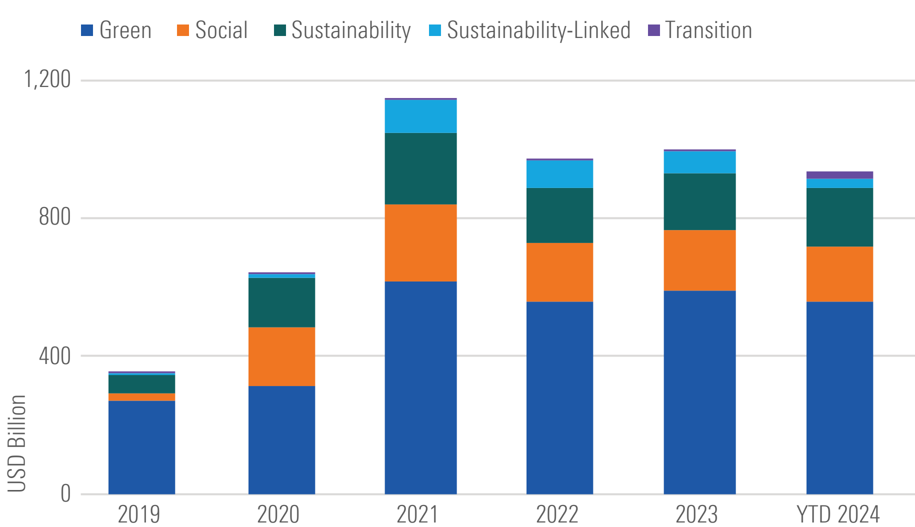
In 2025, we expect the issuance of green, social, sustainable, and sustainability-linked bonds (GSS+) to exceed USD1 trillion again, from just under that mark at the end of 2024,[1] driven by a continued falling interest rate environment as issuers take advantage of lower borrowing costs.[2]

Growth will continue to be supported by investor demand for sustainable investments[3] and the broader push, albeit with regional differentiation, for companies and governments to align their financing with environmental and social goals. 2024 was a mixed year for GSS+ bonds, with lower sustainability-linked bond and social bond issuances offset by strong issuances of green and sustainability bonds.

### The first EU-compliant green bond will be issued

Green bonds will continue their dominance in the sustainable bond market (approximately 60% of total issuances in 2024, YTD) with the anticipated issuance of the first bonds under the European Union's Green Bond Standard (EU GBS). The EU aims to further strengthen investors' trust in the green bond market with this new voluntary standard by requiring enhanced reporting and verification.
Bonds issued under the EU GBS will be required to allocate at least 85% of their proceeds towards EU Taxonomy-aligned sustainable activities.

**Green, social, sustainable, and sustainability-linked bonds issuance**




Source: Environmental Finance Data, as of December 2, 2024

[1] Total GSS+ volume stood at USD 938 billion as of December 2nd, 2024 according to Environmental Finance
[2] Morningstar's 2025 Outlook: Future Market Investment Strategies
[3] Voice of the Asset Owner Survey 2024 Quantitative Analysis

Issuers in sectors such as Utilities and Real Estate, whose capital expenditures are already well aligned with the EU Taxonomy, are expected to be the most prominent participants and first movers in this market, as are the development banks that finance a large portfolio of activities. Market participants will be particularly attentive to the cost versus benefit analysis of issuing bonds under this stricter regulatory framework, as the higher compliance costs will need to be weighed against the potential benefits of increased investor demand and lower cost of capital for issuers.

### A special focus on financing enabling activities and nuclear

Another important trend to watch in 2025 will be the focus on financing green-enabling activities within green bond issuances. The financing of green enabling activities plays a critical role in facilitating the transition to a low-carbon economy. Examples of green-enabling projects are investments in companies that extract materials (such as lithium), which are vital for green technologies, and companies that manufacture materials (such as insulation) that help reduce emissions in the building sector. The groundwork for this shift was laid in 2024 through ICMA's publication of Green Enabling Projects Guidance.

A further noteworthy trend to watch will be the increased issuance of green bonds to finance nuclear energy-related activities. This trend is most notable in North America and is likely to spread to countries with strong regulatory requirements on key risk mitigants, such as waste management.

Furthermore, climate-related expenditures in low-carbon energy, transportation, and real estate will continue to dominate the allocation of investments. Green bonds issued in the Americas will continue to focus on real estate and data centers.

### Social bonds will continue to mainly finance affordable housing

Social bonds, such as sustainability bonds that include social expenditures, remain particularly favored by financial institutions with well-established frameworks that encompass a wide array of social initiatives. A key area of focus continues to be expenditures related to access to housing, which represents the largest category of social spending.

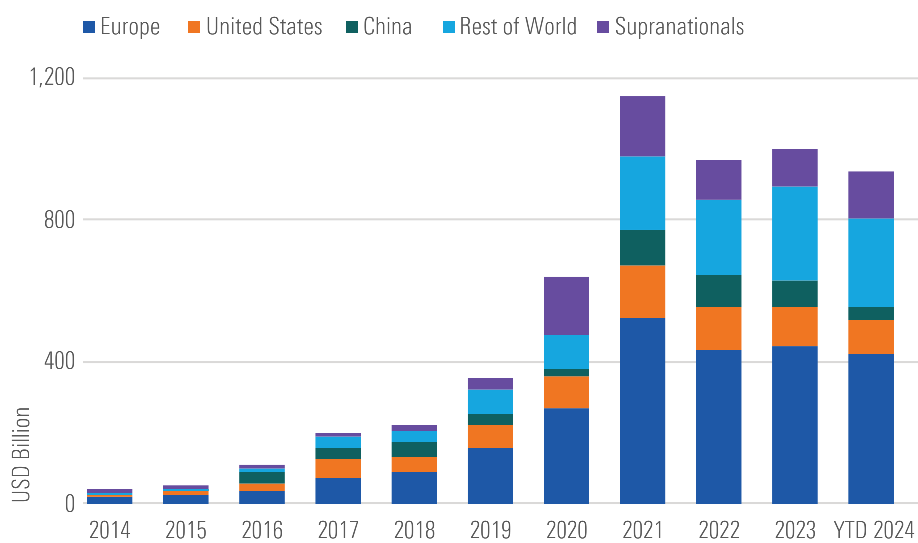
In 2025, we can expect to see a continuation of the innovation in financing social initiatives that we saw in 2024. Some examples are: funding for healthcare and social benefits for domestic workers; women-focused products, such as financial literacy tools; programs aimed at increasing the inclusion of Indigenous populations within supply chains; and efforts to address opioid addiction and prevent overdoses.

### Sustainability linked bonds and financing the transition to a low-carbon economy

A significant shift is underway in the financing landscape, with a growing focus on supporting the transition of entire economies to a low carbon future, rather than on only financing individual activities. This increased focus is particularly on those sectors considered "hard to abate," such as steel, cement, and aviation, as well as reducing emissions across entire supply chains (not just within direct operations).

Regulations such as the EU CSRD and CSDDD, along with the development of global standards by the International Sustainability Standards Board (ISSB), further contribute to the increased focus on transition planning. Sustainability-linked bonds (SLBs) are well positioned to benefit from this focus on transition plans and could see a modest resurgence in 2025. SLBs are fixed income instruments where a key structural element, such as the coupon, is tied to achieving a certain sustainability outcome. That outcome is often related to a key performance indicator and target relevant to a transition plan. The recent maturity challenges in the SLB market will be addressed through advancements in market practices and structuring standards, supported by guidance from organizations such as the Climate Bonds Initiative and ICMA.

**Green, social, sustainable, and sustainability-linked bonds issuance**




Source: Environmental Finance Data, as of 2 December 2024

**Europe** will remain the dominant region of issuance, with USD423 billion in issuance recorded in 2024, year to date. Meanwhile, issuances in emerging markets in Central and Eastern Europe and the DACH region, including Poland and Serbia, are gaining momentum.

In the **Americas**, we expect issuances to stabilize at 2024's low level of less than USD100 billion. In the US, the new Trump administration raises the likelihood of repealing global ESG, climate, and sustainability commitments. However, tax incentives, such as the Investment Tax Credit (ITC) and Production Tax Credit (PTC), are expected to remain intact, as they have significantly contributed to job creation. So long as these investments continue, so will the issuance of bonds to support them.

In the Asia-Pacific **(APAC)** region, transition finance is gaining momentum as a critical enabler of decarbonization, particularly in carbon-intensive industries, such as coal and natural gas. Efforts are intensifying to support coal phase-outs and ensure a "just transition" for impacted communities. Agriculture, biodiversity, and blue financing are also gaining prominence, with ASEAN and Australasia focusing on sustainable agricultural practices and marine ecosystem protection, particularly in coastal and island nations, such as Indonesia and the Philippines. Australia, meanwhile, is focusing on mining critical minerals, as an enabler of the energy transition. Key areas to watch include the critical role of multilateral development banks (MDBs) in financing the transition, particularly in supporting coal phase-outs and renewable energy shifts.

**Africa**, though historically small in terms of its global share of sustainable finance, has seen growth. A key milestone in 2024 is Egypt's first sustainability bond. Looking to 2025, we expect increased issuances from African corporates, sovereigns, and financial institutions, driven by the adoption of local taxonomies, for example in Kenya and Ghana, stronger regulatory frameworks, and greater investment from development and multilateral banks.

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# The reshaping of the global ESG fund landscape

By this time next year, the ESG fund landscape will look significantly different. A large number of funds will change investment objectives and/or portfolios, while some will change names. Others will close.

The ESG fund industry is undergoing a significant transformation with the implementation of anti-greenwashing rules, primarily in Europe, which represents 84% of the USD 3.3 trillion global ESG open-end and exchange-traded fund universe.[1]

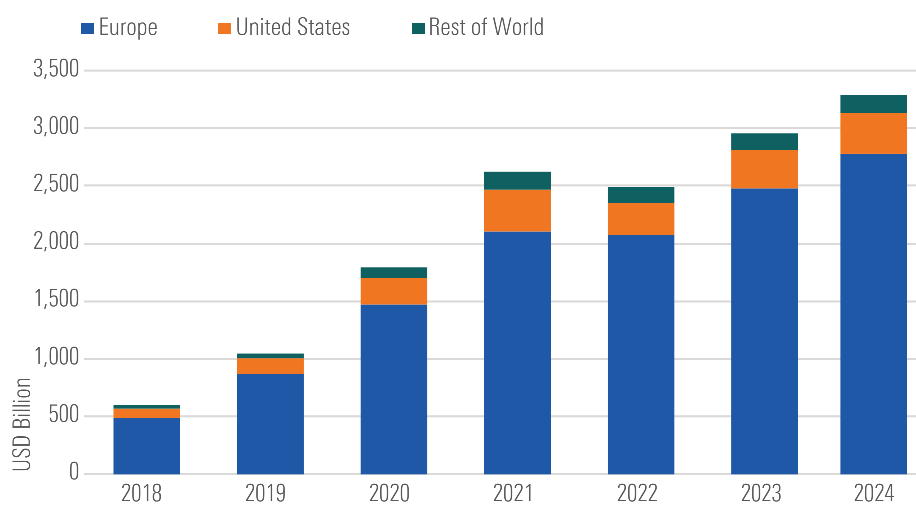
The main transformative driver will be the ESG fund naming guidelines issued by the European Securities and Markets Authority (ESMA). The guidelines aim to protect investors from greenwashing risk by introducing minimum standards for EU funds that use ESG-related terms in their names, such as sustainable, environmental, green, impact, social, and SRI. Fund providers have until May 2025 to apply the guidelines.

**ESMA's fund naming rules may lead to between 30% and 50% of EU ESG funds rebranding**

Last May, we identified around 4,300 funds that were within scope[2] of the guidelines and found that nearly two-thirds of equity funds were exposed to at least one stock that was potentially in breach of the exclusion rules applicable to Paris-aligned benchmarks (PAB) and Climate Transition benchmarks. This represents a significant number of funds that may need to consider divesting from the stocks or rebranding.

Some managers have already made portfolio or name adjustments, but most of the changes have yet to come. We expect an acceleration of rebranding activity in the coming months, potentially resulting in 30% to 50% of EU ESG funds changing their names by mid-2025. These will mostly be funds that use terms such as "sustainable" or "ESG" in their names that, for various reasons, will not want to apply the stringent criteria required to keep these terms, starting with the fossil fuels exclusions imposed by the PAB regulation. Many will simply drop ESG-related terms from their name.

**Global ESG fund assets**




Source: Morningstar Sustainalytics. As of September 2024.

[1] Excluding money market, funds of funds, and feeder funds. Source: Global Sustainable Fund Flows: Q3 2024 in Review

[2] ESMA's Guidelines on ESG Fund Names

For example, "ESG screened," "ESG filtered," and "ESG leaders" will become "screened," "filtered," and "leaders," respectively, arguably making it harder for investors to look for funds with some ESG characteristics. We anticipate that passive funds will be disproportionately affected by the new rules, as active funds benefit from more flexibility. Meanwhile, we expect a small majority of in-scope funds to adjust their investment strategies and/or portfolios in order to meet the new requirements and keep their names.

### SFDR 2.0: New ESG fund categories on the horizon

Another development that will further affect the EU ESG fund landscape is the legal proposal to SFDR review, expected in mid-2025. While the updated rules will not come into force straight away, they may start to influence asset managers' review of their product ranges. Market participants are anticipating a simplification of disclosure requirements and the creation of product categories to replace the problematic Article 8 and Article 9 disclosure classifications.

In June, the three European Supervisory Authorities (ESAs)[3] issued an opinion paper recommending the creation of two product categories: "sustainable" and "transition." The former would rely on the EU Taxonomy to assess the sustainability of the assets, while the latter would focus on assets that are not yet sustainable but are aiming to become sustainable over time. There could even be a third category for other ESG strategies. These new product categories could potentially supplant the ESMA fund naming guidelines.

### Expect more transition funds

In response to the ESMA fund naming guidelines and in anticipation of SFDR 2.0, investors can expect a larger range of transition strategies on offer. Some of the funds that have terms such as environmental, ESG or green in their names will reposition themselves as transition funds, where the less constraining Climate Transition Benchmark exclusions apply, and for which demand is growing. Indeed, investors are increasingly looking to align their portfolios with real-world outcomes and, in the context of climate change, with real-world decarbonization.

### UK SDR's sustainability labels face a laborious start

Meanwhile, in the UK, ESG funds that use the words "sustainable," "sustainability," or "impact" in their names will be forced to drop these terms by April 2025, unless they opt for one of the four SDR labels.[4] The labelling regime, which is part of the anti-greenwashing Sustainability Disclosure Requirements (SDR), has proven challenging to implement and has had a low initial uptake. At the time of writing, fewer than 45 funds have had their labels approved by the Financial Conduct Authority, out of more than 400 UK-domiciled funds[5] with ESG-related terms in the names. In addition to the uncertain investor demand for labels, asset managers have been discouraged by the strict requirements set by the regulator.

Label adoption will increase next year but we do not expect it to exceed 150-200 funds, depending on investor demand and product development. Choice will remain limited, with an under-representation of passive and fixed income options. Meanwhile, the non-labelled ESG fund universe could end up being larger than the labelled ESG fund universe, perhaps an unintended consequence of the regulation. As a preliminary indication, Morningstar has already received consumer-facing disclosures for 218 non-SDR-labelled funds.

### ESG fund closures will accelerate

Finally, asset managers' review of their ESG product ranges to comply with the various European anti-greenwashing rules will inevitably lead to higher ESG fund closures. 2024 is set to be the first year in which ESG fund closures exceed ESG fund launches, with 250 ESG fund closures across Europe (156 liquidations and 94 mergers) in the first nine months, compared to 189 fund launches. Funds that have not attracted enough assets or have underperformed will be the most likely to close next year. There were 5,581 European-domiciled ESG funds in the Morningstar database at the end of September.

### US ESG funds still in decline

Elsewhere, the USD353 billion US ESG fund market has already started to shrink in terms of number of offerings (although not in terms of assets. These continue rising, supported by market appreciation). There were 595 ESG funds at the end of September, compared with 647 at the beginning of the year. Over that period, 36 funds closed and 13 dropped their ESG mandate.[6] US ESG funds have suffered combined outflows of USD36 billion over the past couple of years. The reduced investor appetite can be explained by a combination of factors, including the overall underperformance of ESG funds in recent years, greenwashing concerns, and the politicization of ESG investing.

[3] Including EBA, EIOPA and ESMA.
[4] PS23/16: Sustainability Disclosure Requirements (SDR) and investment labels
[5] Overseas funds are currently out of scope.
[6] The rest are newly launched funds.

Looking ahead, under the new Trump administration, we can expect investor demand for ESG funds to remain subdued and more funds to close or be repurposed. Furthermore, any public initiative to promote this type of investment will be shelved. This is already the case for the SEC's proposal in March 2022 to standardize disclosures concerning funds' incorporation of ESG factors. The proposal identified and defined three broad types of ESG funds (ESG integration, ESG focused, and impact) to which different levels of required disclosure would apply.

**Continued growth in the rest of the world**

In the rest of the world, where principles-based approaches are favored, we do not expect any new regulations to impact local ESG fund markets, with perhaps the exception of Australia where the development of labels is being considered.

ESG fund assets in the rest of the world, which account for 5% of global ESG fund assets, should continue growing, but at a slower pace than during the peak 2020-2021 period. Growth will be driven by continued interest in sustainability issues, but challenges around data quality and greenwashing are likely to remain.

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# Biodiversity finance: Time to scale

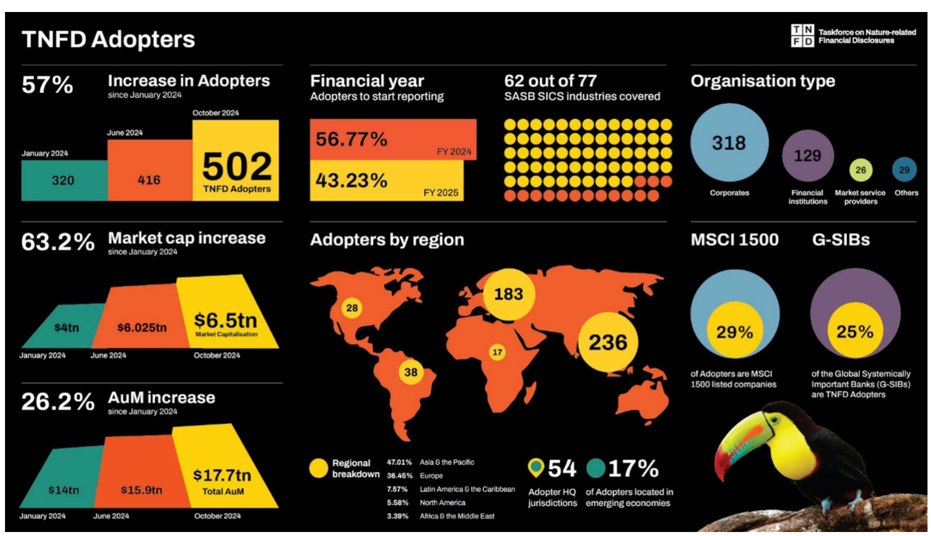
We stand at a turning point for nature finance. New solutions, such as disclosure frameworks, financial tools, eDNA, and satellite imagery, are poised to be transformative.

As we move into 2025, it is widely acknowledged that nature, as an asset class, is mispriced. This misguided pricing signal has led to the ongoing degradation of biodiversity, which ranks among the most severe global risks of the coming decade.[1] Yet, while biodiversity loss is gaining traction as a priority for risk management, its potential for long-term value creation remains largely untapped.

Two years after the adoption of the Global Biodiversity Framework, which set global targets to halt and reverse biodiversity loss by 2030, the subsequent UN Biodiversity Conference (COP16) in Cali, Colombia, was expected to solidify its implementation at the national level. Instead, only a minority of countries presented implementation plans, and a consensus was not reached on key issues, such as a strategy for mobilizing finance and a framework for monitoring progress. These discussions will resume in February 2025 in Rome.

Despite these setbacks, COP16 marked a significant shift: biodiversity is now firmly on the private sector's agenda. The financial sector's understanding of biodiversity as a financial issue has advanced significantly, demonstrated by its engagement at the conference and the panel discussions held. Over the past two years, initiatives such as the Taskforce on Nature-related Financial Disclosures (TNFD) have translated biodiversity into terms of financial risks and opportunities, enabling investors to engage with the issue more effectively.

**Geographical distribution and profile of TNFD adopters**




Source: TNFD. Data as of October 2024.

[1] World Economic Forum (2024). Global Risks Report 2024.

**Nature-related data: No longer an excuse**

The era of insufficient nature-related data is coming to an end. With over 500 organizations expected to start reporting on a voluntary basis from 2025 and 2026, in line with the TNFD recommendations, and more than 11,000 companies mandated to report in 2025 under the EU's Corporate Sustainability Reporting Directive (CSRD), the availability of biodiversity data is poised to accelerate.

While this data will initially be regionally skewed – over 80% of TNFD early adopters are based in Europe and Asia-Pacific[2] -- global alignment will eventually come as the International Sustainability Standards Board (ISSB) is likely to incorporate nature into its standards.

The question for investors will shift from if they will access nature-related data, to how effectively they will use it to inform decisions.

**Investing in nature: Appetite versus uncertainty**

The rise of innovative financial mechanisms, such as debt-for-nature swaps, BBVA Colombia's biodiversity bond, and the recently launched biodiversity credit market framework,[3] signal growing appetite for nature-related investments. Yet, most investors remain hesitant, perhaps constrained by regulatory uncertainty and undefined nature transition pathways.

Stronger political signals are essential to unlock this momentum and enable markets to move forward. By the close of COP16, only 22% of parties had submitted their National Biodiversity Strategies and Action Plans (NBSAPs) – the key tool to formalize roles and responsibilities for non-state actors, including the private sector. Sector-specific nature transition pathways are another missing piece of the puzzle. These pathways will enable investors to assess whether companies are contributing sufficiently to halting and reversing biodiversity loss by 2030.

**A step change: Linking profits to nature**

A significant outcome of COP16 was the establishment of the Cali Fund. Under this mechanism, companies benefiting from plant and animal genetic information – such as those in the pharmaceutical, cosmetic and biotechnology industries – should contribute a share of their profits or revenues to a global fund for the countries and Indigenous Peoples that steward nature.

While voluntary for now, the Cali Fund represents a transformative shift: it directly links corporate profits to biodiversity conservation. This is a step toward embedding the value of nature into financial systems.

**The investor's role**

The foundational elements for nature finance are now in place. From disclosure frameworks to innovative financing mechanisms, investors have the tools to elevate nature finance. In addition, technologies such as eDNA and satellite imagery are becoming more affordable and precise, allowing for granular assessments of nature-related impacts and dependencies.

For those yet to act, the first step is clear: assess exposure to nature-related risks to the extent possible. This will provide the insight to target companies for engagement, leverage shareholder proposals, and ultimately align capital with activities that protect and restore nature, rather than exploit it. Shareholder proposals over the past year, such as those targeting PepsiCo to report on biodiversity or Starbucks to assess its biodiversity impacts and dependencies, demonstrate a powerful way investors can amplify their expectations and drive change.

**A turning point for nature finance**

As 2024 closes, we stand at a turning point for nature finance. The building blocks that did not exist a few years ago are in place, but the next chapter is more challenging: to scale these solutions and drive transformative action across the financial system.

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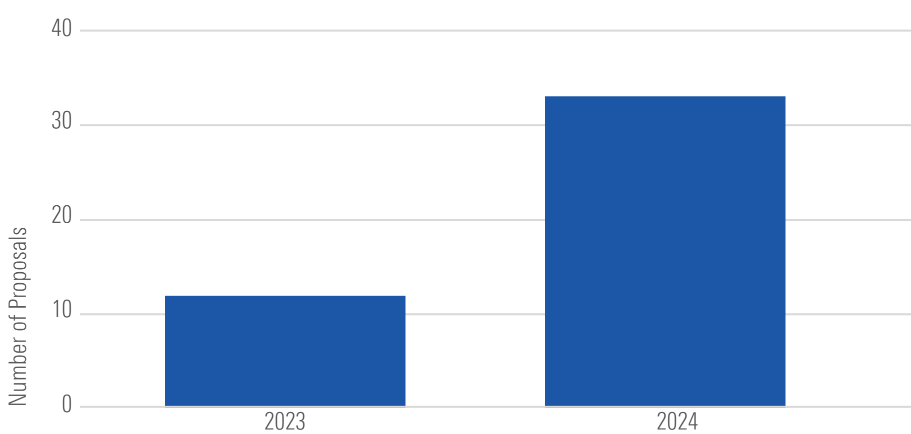
**Biodiversity and nature-related shareholder proposals**




Source: Morningstar Sustainalytics ESG Voting Policy Overlay. December 2024.

[2] Taskforce on Nature-related Financial Disclosures (2024). "Over 500 organisations and $17.7 trillion AUM now committed to TNFD-aligned risk management and corporate reporting"

[3] International Advisory Panel on Biodiversity Credits (2024). "Framework for high integrity biodiversity credit markets"

# The ethics of AI

We expect Trump's likely repeal of Biden's AI Executive Order to materially increase ethical risks, at a time when AI poses greater environmental and social challenges.

Artificial Intelligence was a prominent investment theme in 2024, and is likely to continue to rise on the agenda of sustainability-focused investors in 2025.

Artificial intelligence holds great potential to help combat climate change and achieve sustainability goals across industries. For example, machine learning models can analyze energy usage patterns and optimize energy consumption, significantly reducing greenhouse gas emissions. Technologies like satellite imagery analysis and drone monitoring can help track deforestation, biodiversity loss, and water quality. By analyzing logistics data, AI systems can also enhance supply chain traceability, identify resource inefficiencies and ensure ethical sourcing of materials.

**Investors are optimistic about AI**

According to Morningstar's latest survey, asset owners are hopeful that the adoption of AI will increase in the next five years across all aspects of ESG investing. More than eight out of 10 (82%) hope adoption will increase at least moderately to help with data collection. When it comes to ESG reporting, 77% are hoping for more AI adoption. Asset owners are also optimistic about the adoption of AI to improve portfolio construction (74%) and ESG analysis (71%).

Power-hungry AI … An environmental dilemma puzzling tech firms, clients, and investors.

**Rapid AI adoption gives rise to new risks**

AI's contributions to sustainability are promising. However, we believe its rapid adoption in recent years has revealed significant risks for investors. AI-related risks range from the impact of AI on the environment to social and human rights issues. We anticipate these risks will be evident in the likely scenario of fewer regulations in the US. The Trump administration is expected to repeal Biden's AI Executive Order and replace it with a less risk-centered policy.

**Power-hungry AI … An environmental dilemma puzzling tech firms, clients, and investors**

Tech users and climate-conscious investors should be aware that the substantial energy demands of AI technologies could divert green electricity from other critical sectors that need it more urgently to achieve their decarbonization goals. This year, Microsoft and Google announced increased carbon emissions due to the expansion of their data centers to serve AI demand. The firms have also disclosed ambitious plans to secure new renewable energy sources in order to meet future electricity needs and net zero goals. Despite setting a goal to source 100% clean energy to power data centers, Big Tech's ambitions will remain structurally challenged by the intermittent nature of renewable energy sources, and the fact that it takes time to build new green and grid capacities. Their AI models will therefore still need to rely, at least partially, on fossil fuels – mainly gas – in the years to come.

**Privacy breaches, biases, fake news, copyright infringement: A host of new risks related to AI**
On the social side, investors need to monitor companies' AI policies – or the lack of them. Companies that use AI to collect data, for example, need to have robust policies and processes in place to avoid data privacy breaches and misuse of consumer information. There are particular concerns about monitoring and surveillance applications. A lack of oversight and transparency over AI applications can also result in the development of AI systems that perpetuate biases and increase discrimination against marginalized groups. Lax practices represent high legal and reputational risks, which can lead to sanctions, and eventually financial losses. For example, in May 2023, Meta was fined USD1.3 billion by the EU for mismanagement of its data, violating the General Data Protection Regulation (GDPR).

Investors also need to consider the implications of AI with regard to the dissemination of information, in light of the right to freedom of opinion and expression. AI-generated misinformation and disinformation was listed in the 2024 Global Risks report by the World Economic Forum as the number two risk that could present a material crisis on a global scale. The potential for AI to manipulate information became more apparent during the 2024 US election campaign, in part through the sharing of politically sensitive deepfakes and the creation of fake news articles and social media posts.

Meanwhile, there are growing concerns about foundational AI models being trained on copyrighted material, potentially resulting in legal action due to copyright infringement.[1]

**Divergent AI regulations may negatively impact AI ethics**
An issue arising from the expected deregulation of AI in the US is the contrast it will create with the rest of the world, and the EU in particular. Through the Artificial Intelligence Act, signed in June, the EU aims to establish itself as a leader in ethical AI, bearing the risk of weakening the union's competitive position. EU companies and investments may leave in favor of the US to benefit from laxer regulations. This, in turn, could have adverse implications for the global landscape of AI ethics.

**Investors play a key role in promoting responsible AI use**
Currently, principles on responsible AI use are mainly voluntary commitments made by companies themselves. However, investors have expressed concerns over the transparency and substance of those efforts. With legislation on AI evolving, it is even more pertinent for investors to take the lead on guiding companies in adhering to best practices and this approach has already been initiated by some investors. In February 2024, various shareholders of Alphabet, Amazon and Meta filed proposals seeking to improve company practices pertaining to AI, finding that gaps in oversight and accountability translated into material risks.

Finally, the accelerated adoption of AI is largely expected to lead to significant workforce disruptions, including job losses, particularly in industries transitioning from manual to automated processes. Contrary to previous waves of automation, now there is the potential to automate not only highly repetitive industrial or service processes, but also intellectual and creative tasks previously deemed to be secure, e.g., storytelling, visual design, and voice acting. The frontier of what constitutes commodified work is shifting rapidly. Investors, therefore, must keep in mind the social impact of these transformations. Without adequate social safety nets or regulations, companies could face operational challenges and public backlash.

To navigate this complex environment, investors should adopt a proactive approach by conducting comprehensive due diligence on companies and engaging with them to promote responsible use of AI, transparency, and foresight, as it pertains to the impact of AI on the future of their business.

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[1] A.I.'s Original Sin - The New York Times

## About Morningstar Sustainalytics

Morningstar Sustainalytics is a leading ESG research, ratings, and data firm that supports investors around the world with the development and implementation of responsible investment strategies. For 30 years, the firm has been at the forefront of developing high-quality, innovative solutions to meet the evolving needs of global investors. Today, Morningstar Sustainalytics works with hundreds of the world's leading asset managers and pension funds who incorporate ESG and corporate governance information and assessments into their investment processes. The firm also works with hundreds of companies and their financial intermediaries to help them consider sustainability in policies, practices, and capital projects.

For more information, visit www.sustainalytics.com