

ETF INSIDER

FEBRUARY 2024 • EUROPE'S LEADING ETF MAGAZINE FOR PROFESSIONAL INVESTORS

Fund selectors reveal biggest risks for 2024

Hidden dangers
beneath the surface



Expert Investors:
John Leiper from Titan
Asset Management

ETF Buyers Club:
Eduardo Mezza on
low volatility strategies

What next for ETFs
following a period of
market overexuberance?





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Overexuberance abound

Welcome to the February edition of *ETF Insider*, the first ETF magazine dedicated to professional investors across Europe. Each month, we produce analysis on a specific area of the market, be that fixed income, emerging markets or factors while also providing expert insights into the latest on asset allocation and portfolio construction, always through an ETF lens.

This issue primarily focuses on the outlook for markets over the next 12 months. When writing the introduction to the February 2023 edition of *ETF Insider*, the narrative was very similar – markets are pricing in more interest rate cuts in the US than the Federal Reserve (or the majority of fund selectors *ETF Stream* has spoken to) are signalling. The unexpected resilience of the US economy is the key reason why rates have stayed higher for longer. This scenario looks set to continue over the next six months following positive jobs data and US inflation beating analysts' forecasts recently.

While markets are still pricing in an 89% chance of as many as seven rate cuts this year, fund selectors are not so sure. Short-duration bond and TIPS ETFs have seen a pick-up in demand so far in 2024 amid concerns the Fed will need to keep higher rates than market expectations in the face of ongoing economic resilience.

This scenario would sink long-duration US Treasuries which saw booming demand last year and significant outperformance following Fed's dovish pivot last December.

Throw a concoction of geopolitical and election risks (p.26) into the equation and the outlook for fixed income does not look as attractive as at the start of last quarter, highlighted by many fund selectors when assessing their biggest risks to markets in 2024 (p.34). Meanwhile, I ask fund selectors where they would like to see further innovation in UCITS ETFs to help them construct more resilient portfolios (p.20). It is clear there is still some way to go in fixed income and actively-managed products.

Elsewhere, keep an eye out for a deeper analysis on the outlook for fixed income from Saxo Bank's Althea Spinozzi (p.38), while ETF Buyers Club member Edoardo Mezza, director at Banca Patrimoni & Sella, examines a new approach to low volatility investing (p.16), as well as the usual 'Education Corner' (p.12), 'ETF of the month' (p.13) and 'Fund Fights', where *ETF Stream* compares the strengths and weaknesses of similar ETFs (p.14). Finally, I want to highlight our Expert Investors series where *ETF Stream* interviews fund selectors about their asset allocation and ETF usage (p.11).

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News & views

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ETF trading in Europe: Challenges ahead

CSDR and T+1 settlement risk widening ETF bid-ask spreads

By Tom Eckett

The introduction of T+1 settlement combined with the Central Securities Depositories Regime (CSDR) is creating a myriad of challenges for liquidity providers which will ultimately lead to higher trading costs for ETF investors.

Last December, the European Securities and Markets Authority (ESMA) issued a consultation with the market over plans to introduce progressive penalty rates for settlement fails under CSDR.

Under the proposed models, penalty rates could increase to 12.5 basis points per day if ETFs fail to settle six days after the intended settlement date (ISD).

Europe's regulator is determined to improve settlement rates on the continent without the need to introduce the

controversial mandatory buy-in regime which contractually requires authorised participants to source securities in the event of a settlement fail.

The introduction of higher fines for settlement failures is an attempt to deter liquidity providers from failing on purpose to avoid the costs of creating a new basket. However, the move to implement harsher rules under CSDR risks leading to unintended consequences for European ETFs.

This is because the European ETF market's structure is unique and highly fragmented. According to data from ETFGI, there are 11,925 listings for 2,967 ETPs versus 3,165 listings for the same number of ETPs in the US.

"There is already an abundance of products within the market place,

which can make it very difficult for the unsophisticated client to understand what they are owning," Simon McConnell, head of portfolio construction at Netwealth, said.

According to Jane Street, because secondary market activity is usually thin – the ratio of secondary to primary market trading is around 2:1 in Europe versus 9:1 in the US – liquidity providers are forced to create ETF units in the primary market which can take longer for orders to settle, especially in cases when an ETF is exposed to a larger portion of Asian securities.

"Changes to the CSDR penalty regime would not change the fact that ETF liquidity providers may still need to source liquidity in the primary market to satisfy investor demand," Jane Street warned.

"In the future, the cost incurred by liquidity providers for failing to settle the ETF with the client by ISD would be significantly larger. That cost would have to be reflected in the quotes provided, significantly widening spreads."

With a move to T+1 looming on the horizon, settlement failures are set to become even more pronounced, especially if fines are increased, which is overall a net loss for investors in the form of wider spreads. Andrew Limberis, investment director at Omba Advisory & Investments, told *ETF Stream* ETF issuers need to improve the quality of many products from a total cost of ownership perspective.

"Specifically within trading and liquidity, but this extends to improvements in product/index transparency, securities lending, voting policies, treatment of income and hedging," he added.

Final word

Overall, the potential for wider bid-ask spreads is a key risk facing the European ETF market and could damage the attractiveness of the ecosystem versus other jurisdictions. This is something regulators will need to acutely aware of as these issues develop over the next 12 months.

"With a move to T+1 looming on the horizon, settlement failures are set to become even more pronounced, especially if fines are increased, which is overall a net loss for investors in the form of wider spreads"

Tom Eckett is editor of *ETF Stream*

Dateline: The month in review

2 January

Sanders: BlackRock, Vanguard and State Street 'oligarchy' threatens democracy



US Senator Bernie Sanders criticised the 'Big Three' US fund giants – BlackRock, Vanguard and State Street Global Advisors (SSGA) – labelling them an “oligarchy” that poses a threat to democracy. Sanders highlighted their collective management of \$20.7trn assets and huge shareholder presence in 95% of S&P 500 companies, raising concerns about the concentration of economic and political power. The growth of passive investing has contributed to their dominance, with research suggesting their influence extends to about 23% of the voting power in S&P 500 companies, a factor that has sparked increased scrutiny of their practices and corporate governance roles.

3 January

London 'isolated' following Brexit, Euronext CEO Boujnah warns



Post-Brexit, London's capital markets have become increasingly isolated, Stephane Boujnah, CEO of Euronext,

8 January

Pacer ETFs to enter Europe with flagship Cash Cows range

Pacer ETFs, a \$35bn US issuer, is set to expand into the European market in February, introducing four of its leading 'Cash Cows' ETFs as UCITS. These include large



cap, small cap, developed markets and global ETFs, all originating from its successful US series. The firm's US-listed 'Cash Cows' ETFs – which focuses on companies with high free cash flow yield – have amassed \$28.2bn assets since the start of 2022, underpinning Pacer ETFs' rapid growth.

argued, with just five IPOs on the London Stock Exchange (LSE) in Q3 2023, contrasting with the success of European exchanges. Boujnah pointed out that while New York poses a challenge for London due to its shrinking liquidity pool, this is not the case for Europe, where Euronext now accounts for a large portion of trading and listings, doubling London's market capitalisation and trading volumes on some days.

4 January

DWS calls for new SFDR labelling regime

DWS proposed a revision of the Sustainable Finance Disclosure Regulation (SFDR) – in response to the European Commission's consultation – where the asset manager advocated for a new labelling system that backed splitting the existing 'light green' Article 8 and 'dark green' Article 9 into new product categories. The firm also suggested enhancing stewardship disclosures to support this new system. The move – largely in line with many of the responses calling for a new labelling regime – would run contrary to the UK's Sustainable Disclosure Regulation (SDR), which reduced the requirements on stewardship following its consultation.

9 January

Passive funds to be 'significantly underrepresented' under FCA's SDR

Under the Financial Conduct Authority's (FCA) Sustainable Disclosure Regulation (SDR), passive funds are likely to be significantly underrepresented in the UK, according to Morningstar research. Only 7% of passive funds for sale in the UK are expected to receive one of the four sustainability labels defined by the FCA. Most passive funds available for sale in the UK are registered as overseas ETFs, domiciled in Ireland or Luxembourg and are therefore not in scope. It comes as the FCA unveiled the final rules for SDR in late November, adding a fourth label – 'Sustainability Mixed Goals' – to sit alongside its 'Sustainability Focus', 'Sustainability Improvers' and 'Sustainability Impact' categories.

15 January

Asset managers feel the pinch as ETF launches drop by a third

ETF launches in Europe dropped by a third last year due to rising interest rates and the increased cost of seed

capital for asset managers. According to Morningstar, only 254 ETFs were launched in 2023, a decrease from 381 in 2022 and 391 in 2021, marking a deviation from the yearly average of 268 since 2008. Many of these closures occurred in thematic space which tends to have a growth-stock bias. Despite these challenges, the European ETF market saw substantial inflows of \$158bn in 2023.

15 January Which ETF issuers dominated Europe in 2023?

DWS, Vanguard and JP Morgan Asset Management (JPMAM) were among the standout performers in 2023, a year when European exchange-traded products (ETPs) captured \$158bn in inflows, the second-highest on record. Fixed income ETFs saw \$70bn inflows throughout the year, with BlackRock and DWS major beneficiaries in this sector, capturing 55% and 16% of fixed income ETF flows, respectively. DWS rebounded with \$22.5bn net new assets while Vanguard's focus on low-cost ETFs led to significant gains, crossing the \$100bn assets under management (AUM) milestone. JPMAM also made strides in active ETFs, drawing in 77.7% of flows in this sector.

16 January Why bitcoin UCITS ETFs will not exist



Despite the approval of spot bitcoin ETFs in the US, Europe has remained resistant to incorporating crypto assets into UCITS ETFs, largely due to regulatory concerns. Currently, around \$9bn is invested in crypto exchange-traded products (ETPs) in Europe, structured

as exchange-traded notes (ETNs) rather than UCITS ETFs. Despite some loopholes allowing occasional crypto exposures in UCITS funds, key European regulators like the Central Bank of Ireland (CBI) and the Commission de Surveillance du Secteur Financier (CSSF) remain sceptical, citing significant risks associated with crypto investments.

17 January VanEck launches \$13bn US moat ETF in Europe



VanEck expanded its ETF offering in Europe with the launch of two US wide moat ETFs, the VanEck Morningstar US Wide Moat UCITS ETF (MOTU) and the VanEck Morningstar US SMID Moat UCITS ETF (SMOT). MOTU, which replicates the Morningstar Wide Moat Focus index and SMOT, tracking the Morningstar US Small-Mid Cap Focus index, invest in US stocks and small-mid cap companies, respectively, identified as having competitive advantages.

22 January ETF investors to face higher costs following ESMA's CSDR proposals, Jane Street warns

Jane Street warned trading costs for ETF investors are set for a "substantial increase" due to the European Securities and Markets Authority's (ESMA) proposed penalty rates for settlement failures under the Central Securities Depositories Regime (CSDR). The changes – which included increasing penalty rates in line with the duration of the failed settlement – could introduce higher costs for end-investors and affect the innovation and growth of ETF products.

Most read January

1 Why bitcoin UCITS ETFs will not exist

2 ETF Stream's portfolio of ETFs to outperform in 2024



3 The challenges of active ETFs

4 Pacer ETFs to enter Europe with flagship Cash Cows range

5 Equal-weight S&P 500 ETFs: 'Magnificent seven' beaters?

6 Investors 'paying the price' for T+1 creation inefficiencies

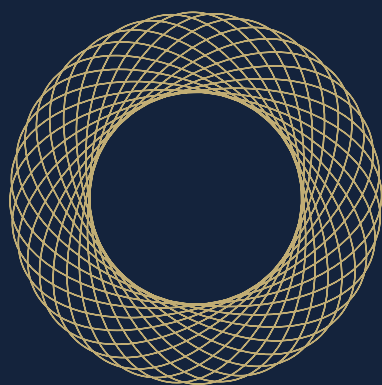
7 Five ETF trends to watch in 2024

8 SEC approves physical bitcoin ETF in the US

9 Five thematic ETFs to outperform in 2024

10 Which ETF issuers dominated Europe in 2023?

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Titan AM's Leiper on uranium, curve steepening and S&P 493 ETFs

Expert Investors is a series where ETF Stream interviews fund selectors on the role of ETFs within their asset allocation. In the hot seat this month is John Leiper of Titan Asset Management

By Jamie Gordon

While a more precarious deflationary pathway may make some fund selectors more thoughtful about their active bets, John Leiper, CIO at Titan Asset Management, said there are still opportunities to be found in ETFs addressing esoteric commodity, fixed income and equity exposures.

Coming off the back of the 'everything rally' at the end of last year, Leiper noted "a healthy pullback in bond yields" through January "to correct for overexuberance".

While suggesting inflation will likely settle at a structurally higher than pre-pandemic levels, he argued the direction of travel remains broadly deflationary and he would expect "a continuation of the disinflationary trend and decline

in bond yields" once the early-year correction settles.

Leiper noted his firm has "neutralised a lot of risk relative to our benchmark" within its equity bucket, including closing out a China tech sector position and resisting the call of single country Mexico allocations, instead favouring of a structural underweight to low-cost benchmark emerging market allocations.

Within a beefed-up developed market roster, Leiper noted a core allocation to best-in-class, low-cost US equity ETFs such as the SPDR S&P 500 UCITS ETF (SPY5), with its recently reduced total expense ratio (TER) of 0.03%.

He added Titan AM is "increasingly tempted" by the case for equal-weighting US exposure, however, he said any approach to addressing the 'forgotten 493' would need to incorporate valuation and quality considerations.

Leiper said he was also "keeping an eye" on new launches such as the VanEck Morningstar US Wide Moat UCITS ETF (MOTU) and VanEck US SMID Moat UCITS ETF (SMOT), which capture companies well-placed to protect their market share through factors including intellectual property, pricing power and brand strength.

Moving along the curve



Much as his firm de-risked in equities by overweighting developed markets, in fixed income Leiper said his team moved closer to benchmark-neutral duration and added allocations to UK and European sovereigns in Q4 last year, having taken profits on being short duration US Treasuries for "most of last year".

Betting on a decline in yields on the short end of the US Treasury yield curve, Leiper took out a position in the Lyxor US Curve Steepening 2-10 UCITS ETF (STPU) when the 2-10-year yield curve spread was between 80 to 90 basis points (bps). Despite some "whipsaw action", he said subsequent yield curve steepening had generated "good profit" and his team "continues to hold" the ETF.

"Our view is as the US economy pulls through and monetary policy normalises, we would expect to come out of inversion and into a more conventional curve structure – and we see that playing out over time," he continued. "That is our key differentiator trade in fixed income at the moment."

Yellow cake

Interestingly, Leiper said where his team is taking active risk, it has reduced the number of ETF-based convictions to focus on uranium exposure, which is serviced by products such as the Sprott Uranium Miners UCITS ETF (URNM) and Global X Uranium UCITS ETF (URNU).

However, he noted a gap in the market is junior uranium miners, which he said "would be good to have in Europe".

Jamie Gordon is senior features reporter at ETF Stream

Ireland vs Luxembourg: Domiciling ETFs in Europe

One of the key decisions issuers will face when launching an ETF in Europe is where it should be domiciled

While there are several jurisdictions asset managers can choose from, Ireland and Luxembourg are seen as the primary locations given their regulatory competence and market expertise.

In recent years, Ireland has grown to become the dominant country in which to house ETFs in Europe. This is down to several factors that the two areas have diverged on, but mainly concerns the favourable Double Taxation Treaty between Ireland and the US.

Tax divergence

The Double Taxation Treaty between Ireland and the US means ETFs with US equity exposure are subject to a 15% rather than a 30% withholding tax on dividends. This is also the case for global equity funds, where the US accounts for roughly 68% of the MSCI World index.

The amount investors benefit from the withholding tax depends on the current dividend yield of the ETF they have invested in. For example, if the dividend yield on the S&P 500 is 2%, investors will



benefit from an annual tax saving of 30 basis points (bps).

ETFs in Luxembourg also have tax advantages due to their exemption from paying an annual subscription tax of five bps, which still applies to mutual funds.

Tax advantages have become a powerful

“Tax advantages have become a powerful driving force behind where ETFs have been domiciled in recent years and helped Ireland become Europe’s dominant jurisdiction for the wrapper.”

driving force behind where ETFs have been domiciled in recent years and has propelled Ireland to become Europe’s dominant jurisdiction for the wrapper.

For example, at the start of 2017, there were 199 exchange-traded products (ETPs) with \$305bn assets under management (AUM) domiciled in Ireland, ahead of Luxembourg which had 146 ETFs with \$115bn AUM, according to data from ETFbook. This has risen to 2,722 ETPs with \$1.1trn AUM in Ireland versus 1,364 ETPs across \$305bn in Luxembourg, as at the end of October 2023.

Regulatory divergence

Notable differences have also arisen between the way the Central Bank of Ireland (CBI) and the Luxembourg regulator, the Commission de Surveillance du Secteur Financier (CSSF), interpret regulatory guidance from the European Securities and Market Authority (ESMA).

The CBI has taken a more literal approach to transposing ESMA’s ETF rules while the CSSF has been more flexible in its application. One such example is the UCITS naming convention. Under the convention, asset managers are required to use ‘UCITS ETF’ in the fund name if it offers an ETF share class alongside its mutual fund share classes.

However, several issuers have created listed share classes of their Luxembourg-domiciled mutual funds without changing the name to ETF. Conversely, HSBC Asset Management was required to relabel four global index funds to ETFs when it became the first issuer to offer listed and unlisted share classes within an Irish Collective Asset Management Vehicle (ICAV).

Another topic on which the two jurisdictions diverge is portfolio transparency. The most recent International Organisation of Securities Commission’s (IOSCO) ETF Good Practices highlighted Luxembourg’s approach to portfolio disclosure on a “lagged basis”, typically monthly.

Ireland on the other hand requires ETFs to publish their portfolios daily, offering more transparency for investors.

With tax and regulatory differences between the two, there is plenty to consider when launching an ETF via an ICAV in Ireland, or a Société d’Investissement à Capital Variable (SICAV) in Luxembourg.





UBS ETF MSCI Japan UCITS ETF (hedged to GBP)

This issue's ETF of the month is UBS AM's UB01, which has soared to all-time-highs on the back of a corporate governance revolution and weak yen

ETF Stream's first ETF of the month in 2024 sees a product from UBS Asset Management ride the wave of Japan equity market momentum while shielding against currency risk at a low fee.

The UBS ETF MSCI Japan UCITS ETF (hedged to GBP) (UB01) has returned 7.1% this year, as at 21 January, and 44.4% over the trailing 12 months.

Japanese equities have boomed over the past year, set against a backdrop of the country's relatively late COVID-19 reopening and calls by the Tokyo Stock Exchange for companies to achieve sustainable growth and enhance corporate value.

One metric the exchange provider highlighted is price-to-book ratio, a multiple it said companies could improve with investments in research and

development, equipment and facilities, business portfolio restructuring and increasing returns to shareholders via dividends and buybacks.

While companies announced a record high number of share buyback plans in 2023, a list published by the Japan Exchange Group revealed just 660 of the 1656 companies listed on its Prime section complied with its request to outline plans to increase their valuations.

While the list is intended to pressure laggards into taking greater public

accountability, it notably targets smaller businesses which struggle to generate returns on capital and engage with shareholders.

UB01, meanwhile, captures the 225 large and mid-cap companies tracked by the MSCI Japan 100% hedged to GBP index.

Additionally, while foreign currency investors in unhedged Japan ETFs have suffered significant performance drag on yen weakness, this has not been the case for those targeting UB01 and its peers.

UBS AM's unhedged MSCI Japan ETF has returned 17.1% and 34.4%, respectively, over the past year and five years versus 44.4% and 86.3% for UB01 over the same periods.

The firm's currency hedged candidate also recently gained an edge against its peer group after its total expense ratio was halved from 0.29% to 0.15% last December, making it the lowest-fee currency hedged ETF capturing a vanilla Japan benchmark.

Looking ahead, investors will be increasingly wary regarding the sustainability of the Japanese equity ascendancy, with the Nikkei 225 and TOPIX having both recently hit 34-year highs.

On a tactical basis, Japan equity ETFs play an important role as a Federal Reserve 'higher-for-longer' hedge. Unless US policymakers start easing sooner than anticipated, relative weakness from the yen should remain in place – as such the continued strength of the US economy and Japanese exports go hand-in-hand.

The other currency variable is if and when the Bank of Japan (BoJ) begins tightening, a scenario State Street's head of global market strategy Michael Metcalfe suggested "has been postponed for now, but the risk has not gone away".

On a strategic basis, the interplay between Japan and China could prove impactful. On the one hand, Japan could be viewed by fund selectors as the 'not China' Asia allocation, with many entering the year overweight the country's equities. However, Japanese companies' exposure to China's economic woes – from property to unemployment and manufacturing overcapacity – could also take a toll.

STAT ATTACK

Ticker	UB01
TER	0.15%
One-year return	44.4%
AUM	\$101m
Constituent count	225

Data as at 21 January



Fund Fights

Global X, BlackRock and HANetf copper miner ETFs

Fund fights is a series where ETF Stream analyses the strengths and weaknesses of similar ETFs. This month, Europe’s three copper mining ETFs go head-to-head

Our first fund fight of the year pits three candidates from the growing roster of copper mining ETFs, seeking to benefit from buoyed demand through the energy transition. The first contender is the \$51m Global X Copper Miners UCITS ETF (COPX), which launched in November 2021.

Its first rival, the \$10m iShares Copper Miners UCITS ETF (MINE), debuted last June. While MINE initially undercut COPX’s total expense ratio (TER) by 10 basis points, Global X announced a fee cut within a month to equalise both products’ fees at 0.55%.

Entering the race last December was the Sprott Copper Miners ESG Screened UCITS ETF (CPPR), with a TER of 0.59%.

While lagging the pack with higher fees, CPPR has led on performance in the brief

period since its launch and returned -6.4% in the month to 22 January, versus -8.4% for COPX and -8.9% for MINE.

Looking at what makes the products tick, COPX tracks the Solactive Global Copper Miners Total Return v2 index of 37 companies with at least 30% revenue exposure to copper mining or “closely related activities” including exploration, refining and recycling.

Each constituent is market cap weighted and capped at 4.75% allocations, with all companies included with a market cap under \$200m limited to a 10% aggregate weight. Next, MINE tracks the STOXX Global Copper Miners index of 34 copper mining companies from developed and emerging markets.

The index is price-weighted, capping companies at 8% and selecting constituents

that derive more than 50% of their revenues from sectors linked to copper mining. After that, the index captures companies with revenue exposure to copper mining above 25%, in descending order. Finally, it adds any absent companies which are among the top 50% in terms of market share within copper mining to represent those extracting high dollar revenues from the sector.

Sprott and HANetf’s CPPR replicates the Nasdaq Sprott Copper Miners ESG Screened index of 27 copper producers, developers and explorers, with a copper ‘intensity’ score of at least 25%. This is based on the extent of their operations focused on searching for, mining or selling copper. Companies with an intensity score of 50% are categorised as ‘group 1’, those with a score of at least 25% are ‘group 2’. Securities are weighted according to modified market cap, with no company comprising more than 9.75% and ‘group 2’ capped at a cumulative weight of 15%.

Notably, all three ETFs leave wiggle room for companies that are not copper mining pure plays. MINE’s net dollar exposure criteria means it captures Anglo-American, which has 15% revenue exposure to copper, according to data from Statista. Meanwhile, both MINE and COPX capture Glencore, whose primary business in coal was extended last year with the acquisition of Tek Resources’ steelmaking coal business.

While CPPR’s more concentrated basket might include less padding, it follows its peers in allocating to BHP, whose primary business is iron ore. Although the company satisfies CPPR’s intensity criteria, its 20.2% revenue exposure to coal last year exceeds the ETF’s ESG screen, which caps constituent revenue exposure to thermal coal at 15%. CPPR also joins its peers in allocating to Ivanhoe and Lundin Mining, both of which have faced public and regulatory backlash for complicity in war crimes and forced labour.

All three ETFs also have exposure to Filo Corp, which one selector told ETF Stream has “no sales and no business model”.

Overall, the three ETFs are important in broadening the range of specialist sectors available to investors. However, they underline the trade-offs inherent in offering liquid and diversified exposure to niche parts of the market, with unique risks that warrant consideration.

STAT ATTACK			
Launch date	22/11/21	21/06/23	06/12/23
Assets under management	\$51m	\$10m	\$1m
Constituent count	37	34	27

Date as at 21 January 2024

Viewpoint: Joachim Klement

Only academics believe in efficient markets

Real markets are not all that efficient

How do investors think about financial markets? If you study finance at university, your teachers will tell you that markets are efficient (or at least largely efficient) and that any new piece of information is instantly incorporated into the share price of a company. Hence, looking at past news about a company should not influence your investment decision. But if you ask retail investors or financial professionals, that is what happens.

Peter Andre and his colleagues conducted lab experiments where

academics, financial professionals, retail investors, and members of the general public were invited to invest in different stocks or the stock market overall. The setup was quite simple. Investors were provided with good or bad news about a company that had been released four weeks ago. Then they were asked to predict the future return of that stock and interviewed about their reasons for making that forecast.

The results are summarised in the chart below. Essentially, the vast majority of academics followed the

prescriptions of the efficient market hypothesis and did not change their forecasts in response to old news, good or bad. They argued that this information was fully reflected in the share price and hence has no impact on future returns.

Financial professionals, retail investors and members of the public alike changed their return expectations in response to this news. If the news is good, they increase their return expectations even if that news item was released four weeks ago. If the news is bad, they reduce their return forecasts.

The main argument for doing so is the persistent impact of the news on future earnings and dividends. They argue that because of the good news, earnings growth should be stronger, which should result in higher share prices going forward, etc.

Academics would reply that this is a circular error because the increased future earnings are what has driven the share price higher already.

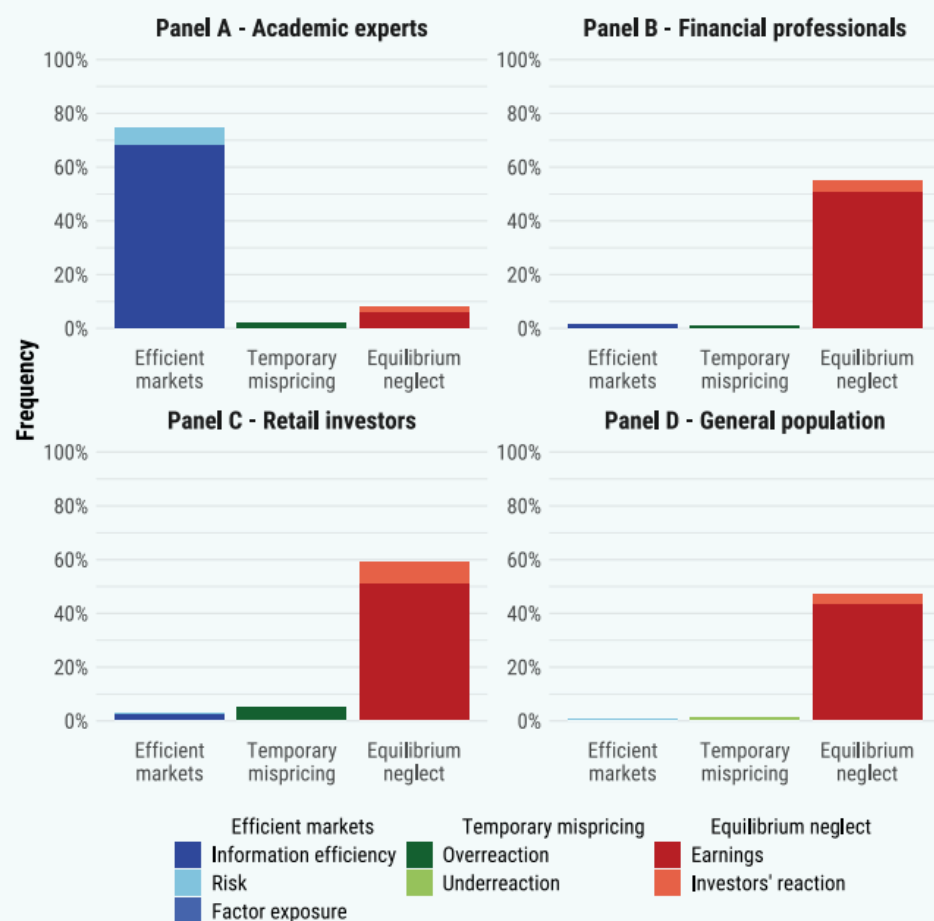
But I would argue that the academics are wrong. Or rather the efficient market hypothesis on which this academic view is based is wrong. There is plenty of evidence that behavioural effects lead to 'market inefficiencies'. One of these is herding and many studies have shown that analyst up- and downgrades of earnings do not happen in a vacuum. Rather, analyst up- and downgrades come in waves. And these waves influence share prices and create lasting price trends.

And that is why it makes sense to anticipate higher returns in response to positive news even if that news is somewhat stale. Real markets are not all that efficient and certainly not as efficient as academics want to believe. Rather, markets are messy – part psychology, part fundamentals. And unless you incorporate the psychology of markets and investors into your investment process, you are almost certain to fail as an investor.



Joachim Klement is investment strategist at Liberum Capital and author of the Klement on Investing blog

CHART 1: REASONING UNDERLYING FORECASTS BY DIFFERENT INVESTOR GROUPS



Source: Andre et al. (2023)

ETF Buyers Club

The ETF Buyers Club is a community for investors active in the world of ETFs and is the first peer-related group of its kind. Each month, a member of *ETF Stream's* ETF Buyers Club will analyse some of the most important issues facing ETF investors



A new lease of life for the mighty moving averages?

A fresh approach to low volatility

By Edoardo Mezza

At 123 years old and still fighting fit. This is the incredible longevity of moving averages. Their use is widespread in all scientific disciplines, although they are rarely studied in traditional university courses (at least in Italy). From statistical applications to the measurement of physical or chemical phenomena, moving averages successfully

help those who need to assess an ongoing trend. They are also indispensable in financial market research, where they have been used for many decades. MAs have been through several major economic crises without any questioning of their usefulness. Sophisticated investment models and trading algorithms owe their popularity to complex applications of the idea behind them.

As Professor Jeremy Siegel wrote in his famous book on finance, *Stocks for the long*

run: “A moving average is simply the arithmetic average of a given number of past closing prices of a stock or index over a fixed interval of time.

“For example, a 200-day moving average is the average of the closing prices over the past 200 days. For each new trading day, the oldest price is dropped, and the latest price is added to calculate the average. Analysts claim that a moving average allows investors to see the underlying trend of the market without being distracted by the day-to-day volatility of the market.”

Now this wonderful algorithm may have a second life.

I had a look at the 21-day moving average of the S&P 500 index and suddenly thought it would be a brilliant index. Moving averages are smoothed, always close to the index from which they are derived and perform better during market downturns. During the upswings of the index, depending on the length of the moving average chosen, they will remain close to the index, although below it. In the long term, they closely track it. Moving averages would be the perfect index to use in low volatility strategies. So, I decided to look at their mathematical properties.

Using the general formula for moving averages, it is possible to disentangle the reasons for their lower volatility compared to the underlying index. It all depends on the variance of the moving average, which is always roughly a slice of the variance of the index. Specifically, the variance of a moving average is the ratio of the variance of the underlying index to the number of days of the moving average chosen. A one-day moving average is known to coincide with the trend of the chosen index. So is the variance. That of a 20-day moving average is one twentieth of the index's variance. Variance is the mother of standard deviation and standard deviation is the mother of volatility. This property is deterministic. It is not probabilistic. This means that it can be replicated.

The fact that the variance of the moving

average is only a small fraction of the variance of the index results in an exceptional risk-return ratio. Hence the idea of turning it into a new and more brilliant low-volatility index and strategy.

Therefore, the TRENDYX strategy proposes an original application of the leading mathematical properties of moving averages to create a new generation of financial instruments, the first of its kind.

It transforms moving averages into an autonomous investment tool capable of isolating the trend from the short-term random fluctuations, the signal from the noise. It is therefore characterised by lower equity volatility, comparable to that associated with investing in bonds. TRENDYX therefore represents a change of perspective: from investing with trends to investing directly in trends.

Over the 2020-2023 period, which was dominated by an unusually devastating series of adverse events, low-volatility strategies delivered very modest risk-adjusted results. The MSCI World – in US dollars – delivered an annualised performance of 7.38% with a volatility of 19% while its low-volatility version delivered an annualised performance of 3% with a volatility of 14.8%. Over the same period, the TRENDYX strategy would have generated an annualised return of 7.3% with a volatility of only 4.6%. No less interesting is the size of the drawdowns.

They are much smaller than those typically experienced by traditional indices. This is a significant advantage. The law of compounding makes it easier for the TRENDYX to climb back up and regain previous highs. Moreover, it has an additional advantage in the de-escalation phases of the index. TRENDYX moves at a slower pace and therefore gives the investor time to decide whether to stay in the market or to get out instead. On a risk-adjusted basis, it is a no-brainer. The TRENDYX strategy has consistently been the most efficient and best performing.

Data shows that this innovative idea would have reassured investors during the worst period without causing them serious underperformance against traditional indices.

Of course, if TRENDYX is ever created, it will be through ETFs, which I believe to be the best financial instruments ever invented.

However, there is still a long and difficult road ahead. First, a family of TRENDYX indices will need to be created. Since the ETF that replicates this strategy will inevitably

have to be synthetic, it will also be necessary to assess the willingness of swap providers to supply the flows generated by TRENDYX movements. Most importantly, it will be necessary to understand the extent to which the ETF industry is interested in introducing this new family of low volatility strategies.

At the end of the day, TRENDYX was born by chance. I have just been lucky enough to get out of the conventional box of using a widely known metric. Sometimes I like to think of Oskar Barnack, who designed the

Leica, the first small-format camera. Barnack simply took advantage of the existing cinematographic film, which ran vertically, and used it horizontally, shooting one frame at a time. This is the idea behind the TRENDYX strategy. Using a tool designed for one need for a different one.

Edoardo Mezza is director at Banca Patrimoni & Sella and author of *The TRENDYX Approach: New Frontiers in Low Volatility Strategies*

FIGURE 1: THE TRENDYX APPROACH - NEW FRONTIERS IN LOW VOLATILITY STRATEGIES
How would it have responded to the turbulence of recent years

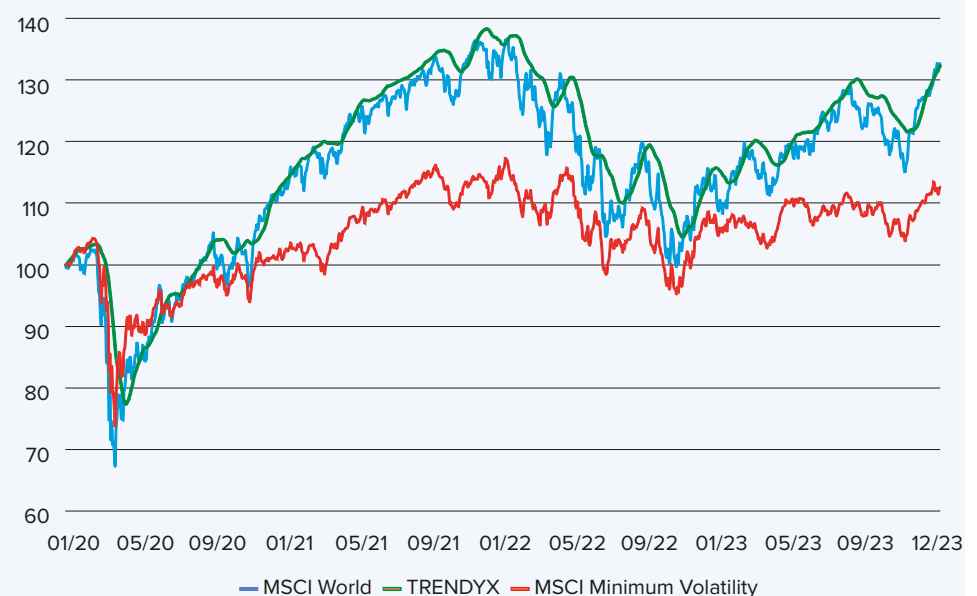
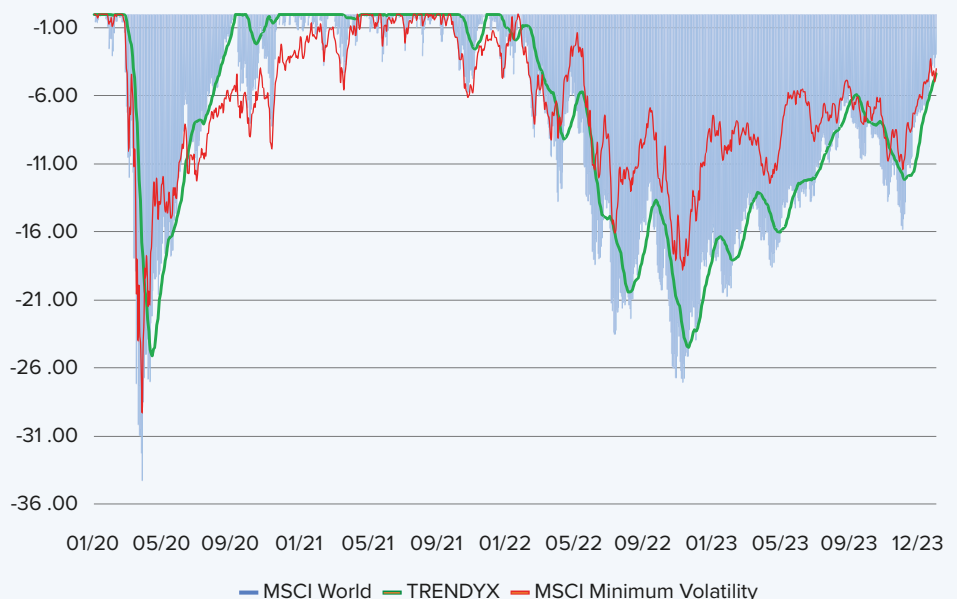


FIGURE 2: MSCI WORLD VS TRENDYX AND MSCI WORLD MINIMUM VOLATILITY
Max drawdown 2020 - 2023



Features & Analysis

The Patient Investor

Searching for the Holy Grail

The fund tips that accompany each New Year remind us that active management trades in hope – and probably always will

By Justin Reynolds

Another year brings another round of articles identifying funds that might – or might not – beat the market. The tradition is now somewhat shadowed by ever deeper investor scepticism towards active funds. Last year fewer than 400 funds launched in the UK, drastically down on the most recent peak of 899 in 2010, and £2.2bn was withdrawn from flagship funds run by Terry Smith and Nick Train.

But the eulogies attending the passing of Berkshire Hathaway legend Charlie Munger proved the industry's abiding respect for the figure of the financial seer. And the turning of the year can tempt even passive investors to rebalance their portfolios towards ETFs that might outperform the humble index.

Hope, then and now

Hope is as old as the stock market itself, nurtured – and exploited – by generations of star managers and mellifluous commen-

tators. Ever since the stock market emerged from the coffeehouses of the City of London around the turn of the 17th and 18th centuries, investors have sought to discern legible patterns amidst the chaos, persistent tendencies that might hold the key to reliable returns.

Thomas Mortimer's 1761 guide to the nascent markets, *Every Man His Own Broker: or, A Guide to Exchange-Alley*, established the template for so much of what was to follow, with its conspirational tone warning readers that "walking the Alley" presented dangers to "honour, honesty, and...good conscience", and its casting of the writer as a Virgil able to lead to reader through the inferno to the opportunity beyond, by means of streetwise advice "intelligible to the meanest capacity".

Apocalyptic imagery notwithstanding, Mortimer's counsel was rather conservative, cautioning the reader to invest in government securities and chartered corporations and ignore "idle rumours of bad news" put about by market manipulators. In today's terms, perhaps, a standard buy-and-hold strategy.

"Ever since the stock market emerged from the coffeehouses of the City of London around the turn of the 17th and 18th centuries, investors have sought to discern legible patterns amidst the chaos, persistent tendencies that might hold the key to reliable returns."



But commentators grew in confidence through the Victorian era, drawing on story-telling innovations pioneered by the great novelists of the day to help readers envisage alternative futures for their money. By the early 20th century, investment advice had developed scientific pretensions, venturing that the market operated according to impersonal laws that could be interpreted by applying the right methodology.

'Technical' analysis claimed to discern cycles in market data that could reliably indicate future price movements. William Peter Hamilton's best-selling *The Stock Market Barometer* (1922) specified rules for identifying windows of opportunity for the buying or selling of stocks that briefly open when trends begin to break down. The technique's credibility was clouded by a certain mystical dimension. One popular guide, Ralph Nelson Elliot's *The Wave Principle*



(1938), maintained that the market moves “in waves of a definite number and direction” according to an esoteric metaphysics he claimed had informed the architects of the Great Pyramid of Giza.

A rival school of thought, ‘fundamental’ analysis, which sought to identify ‘undervalued’ companies that the market might have overlooked, gained momentum in the wake of legislation passed after the Great Crash mandating companies to disclose previously privileged corporate data. Benjamin Graham and David Dodd’s *Security Analysis* (1934) articulated principles for analysing a company’s earning power and ‘intrinsic value’ that still guide value investors.

Faith and knowledge

But the efficient market theories developed at the University of Chicago during the 1950s and 60s put both systems under

increasing pressure. With Burton Malkiel’s *A Random Walk Down Wall Street* (1974), which popularised modern portfolio theory, and the emergence of the first passive products, investment advice seemed to have finally circled back to Mortimer: invest cautiously and stay in the market through thick and thin.

But Malkiel’s book exemplified the conflict that has riven so much financial advice literature over the past 50 years: intellectual acknowledgement of the sheer difficulty of beating the market, set against a stubborn faith that it can be done – consistently. For Malkiel, simply sticking to passive funds was like “telling an investor that there is no hope of beating the averages is like telling a six-year-old that there is no Santa Claus. It takes the zing out of life.”

Invested: How Three Centuries of Stock Market Advice Reshaped Our Money, Markets,

and Minds, an academic history of investment writing published last year, suggests this desire for the visceral thrill of beating the odds accounts for the aggressive tone of so much commentary, and characteristic cultural representations of the financial industry: consider the novels of Martin Amis, Tom Wolfe and Don DeLillo, and, of course, Oliver Stone’s film *Wall Street*.

And the success – consistent of otherwise – of certain celebrity investors continues to suggest that alpha is there for the taking, if one knows where to look. Indeed, there is empirical evidence that smaller value stocks outperform the market over the long run: investors seem to have a chronic propensity to project the success of growth companies onto the blank canvas of the future, overlooking more reasonably valued stocks that can – eventually – come good.

Investor psychology, bottled

It is not quite the conclusive argument for the continued relevance of active funds that value-driven stockpickers are quick to make. Investors who wish to tilt their portfolios towards value can do so by picking one of the many low-cost smart beta funds that employ systematic, replicable, and transparent rules to emulate the alpha that active managers generate. It might be said that such funds have found a way to capture and take advantage of a persistent trait of investor psychology: the tendency to be seduced by glamorous growth stocks at the expense of undervalued alternatives.

But though they make a plausible claim to offer a systematic means of capturing time-worn techniques the best investors have used to eke out returns beyond market beta, smart beta funds oriented towards value have not proved the industry’s holy grail. They only work if investors are prepared to hold, and, given the market’s vagaries, hold for a very long time. And investment history shows that most investors are not so disposed – the human desire for near term gains is too strong. ‘Reason is the slave of the passions’, as the philosophers have put it.

That temptation may be bad news for investor returns, but it is good news for the capacity of active advocates – and financial pundits – to continue to trade in hope.

Justin Reynolds is a freelance journalist and editor of The Patient Investor blog



ETF innovation: What are fund selectors demanding in 2024?

Fixed income innovation should be at the top of ETF issuer's priorities

By Tom Eckett

Fund selectors have called on asset managers to develop more fixed income ETFs as they look to take advantage of the attractive yields on offer. According to data from ETFbook, fixed income UCITS ETFs saw a record \$70bn inflows in 2023 as investors turned

back to the asset class following a decade of quantitative easing and negative yields.

Demand for bond ETFs looks set to continue, with 83% of professional investor respondents stating 2024 will be the year of fixed income versus 40% for equities, in a recent survey conducted by *ETF Stream* and JP Morgan Asset Management. This year, duration positioning will be crucial as

fund selectors grapple with the potential for a deep recession that will drive yields lower or a stronger-than-expected US economy that will force the Federal Reserve to keep rates at elevated levels.

Fixed income ETFs play an important role in allowing investors to pinpoint specific parts of the yield curve which they believe offer the best value.

Sir John Royden, head of research at JM Finn, told *ETF Stream* he wants more granularity in inflation-linked gilt ETFs. The largest UK inflation-linked bond ETF is the £705m iShares £ Index-Linked Gilts UCITS ETF (INXG), however, it has a weighted average maturity of 16.97 years which will underperform in an environment of rising interest rates, even if inflation is also increasing.

Legal & General Investment Management offer the L&G UK Gilt 0-5 Year UCITS ETF (UKG5) but Royden said there could be an even deeper duration split with index-linked



ETFs in both short and medium points on the yield curve. “We have a desire for more precise duration and would love to see more granularity from ETF issuers,” he added.

Echoing his views, Andrew Limberis, investment director at Omba Advisory & Investments, said fixed income is still an area where he would like more control over duration, across both government and corporate bonds and different currencies.

Corporate bond ETFs saw strong demand in 2023, with the iShares Core € Corp Bond UCITS ETF (IEAC) capturing \$5bn inflows, however, there is limited granularity across risk buckets.

Fixed maturity bonds

One area of innovation in 2023 was in fixed maturity corporate bond ETFs after BlackRock brought its iBonds range to Europe last August. Fixed maturity ETFs allow investors to access corporate bonds with specific maturities while benefitting from

“Within the realm of equity funds, thematic products remain attractive for us. Innovation with products that generate decent and stable income would continue to be of interest in an era of elevated inflation and high interest rates.”

the diversification, transparency and liquidity benefits of ETFs.

Oliver Faizallah, head of fixed income research at Charles Stanley, added investors can receive a stream of predictable cash flows over the life cycle of a bond.

He called on ETF issuers to launch sterling-hedged share classes for fixed maturity investment-grade bonds which he forecasted would have great appeal to investors unable to access the direct bond market. “Given the rapid rise in yields experienced lately, these qualities are becoming more apparent,” Faizallah continued. “However, the direct corporate bond market is not retail friendly, with most outstanding bonds available in a minimum size of £100k.

“While these products are becoming more available, a sterling-hedged share class for UK-based investors would be a great addition to the product suite in 2024.”

Active demand

Demand for further product development in the active fixed income ETF space is another area of focus for fund selectors.

Pacome Breton, head of portfolio management at Nutmeg, told *ETF Stream* asset classes such as high yield and emerging markets are ripe for innovation in the active bond ETF space. “This year, we see that actively managed fixed income ETFs will become more interesting than ever,” Breton added.

“As central banks in major developed economies reduce their quantitative tightening measures, the influence of currency fluctuation on emerging market debt emerges as a predominant factor, a broader range of products to offer flexibility of currency exposure would help better manage the elevated US dollar risk.”

Overall, active ETFs in Europe saw \$7.4bn inflows in 2023, up from \$2.6bn the year prior, amid a combination of more available products and investors becoming comfortable with marrying the benefits of the ETF wrapper with active management.

Simon McConnell, head of portfolio construction at Netwealth, said the development of active strategies is “encouraging” for the ETF market. He called for further innovation in areas where the underlying market is liquid such as managed futures and trend-following strategies. “Clearly active strategies within ETF wrappers are becoming more in vogue,” he told *ETF Stream*.

“It will be interesting to see if other active strategies, where the underlying is liquid that were traditionally held in mutual funds could be made available in ETF form.”

Thematic ETFs

Finally, it was a torrid year for thematic UCITS ETFs which saw \$1.1bn outflows in 2023, down from \$4.3bn inflows in 2022, as investors turned away from risk assets amid fears of the impact of higher interest rates.

Limberis stressed the importance for more “well-defined” megatrends that act as a middle ground between traditional sectors and “outlandish” themes as well as more deviation away from market-cap weighting.

Meanwhile, Breton called for more cost-effective thematic ETFs in areas such as energy transition, artificial intelligence and robotics. “Within the realm of equity funds, thematic products remain attractive for us,” he said.

“Innovation with products that generate decent and stable income would continue to be of interest in an era of elevated inflation and high interest rates.”

Final word

There are over 2,750 exchange-traded products (ETPs) listed in Europe, according to ETFbook, so fund selectors are well served, especially in core equity building blocks.

Fixed income is an area of potential disruption for smaller ETF issuers entering the market while the rise of active ETFs is a trend that cannot be ignored.

Tom Eckett is editor of *ETF Stream*

Market overexuberance: What next for ETFs?

Fixed income and equity ETFs finished 2023 with multi-year record returns; 2024 began with markets halving the odds of a March rate cut

By Jamie Gordon

The Federal Reserve's gift-wrapped 'pivot' may have been framed as Christmas come early, however, the disproportionate market response – and managing the subsequent whiplash – is a trial fund selectors will contend with through 2024.

The Federal Open Market Committee's (FOMC's) verbal ending of further policy rate hikes was accompanied by the policymaker guiding three rate cuts totalling -0.75% by the end of 2024.

Before the fateful November meeting, forward market prices had already taken the liberty of factoring in a cut from 5.25%-

5.50% to 4.25%. After the meeting, markets priced in cuts to 3.75%-4%.

This hypothetical dovishness sent investor confidence in fixed income to a 15-year-high, accompanied by the Bloomberg Global Aggregate index booking 10% gains, marking its best two months of performance in data going back to 1990.

Unsurprisingly the giddiness was not confined to fixed income, with a Bank of America Global Fund Manager Survey at the end of the year revealing broad sentiment to be at its most upbeat since January 2022 – as indicated by cash versus equity allocations.

The momentous 'Santa rally' also coincided with the S&P 500 gaining 16.7%, or \$6.49trn in market cap, in eight weeks.

Meanwhile the Nasdaq 100 booked its strongest year since the 'dot-com' bubble and the MSCI ACWI gained for seven consecutive weeks, marking its longest winning streak in almost six years.

Perhaps more of a red flag, however, was the Russell 2000 – home to small caps with lower profitability and higher leverage – gaining 26.8% in eight weeks, while the IPOX SPAC index added 20%.

Scanning a frothy landscape, JP Morgan's global strategy report described markets appearing "overbought and sentiment in complacent territory" as investors piled into a year-end performance chase. This was driven by the emergence of the "immaculate disinflation thesis" – a narrative it warned would be "challenged" in H1 as the disinflation faces hurdles.

George Granville, partner at Courtville Partners, warned "many factors" suggest inflation will remain above 2% target levels meaning the Fed funds rate is likely to settle at 4% or above and those hoping for a return to post-2008 low rates "will be disappointed".

Fixed income mini correction

Some of these warning lights began flashing in the opening weeks of the year, with December prints revealing US new jobs coming in 46,000 above expectations, while retail sales growth and consumer price inflation (CPI) both 20 basis points higher than predicted.

Following a speech by Fed Governor Christopher Waller, who said there was "no reason to move as quickly or cut as rapidly as in the past", US 10-year Treasury yields saw their largest daily increase in over two months, according to Deutsche Bank Research.

With CME Fedwatch pricing of a March cut by the Fed falling from 90% to 42% within a fortnight, JP Morgan noted long duration trades have taken a "tactical respite", with 889,000 contracts taken out by hedge funds against 10-year Treasuries in mid-January marking the largest short position on the duration in history.

However, a delayed timeline on cuts and a less straight path to deflation could suggest yet more to be shaken out of last year's pivot rally in fixed income.

Wei Li, global chief investment strategist at the BlackRock Investment Institute, warned markets are still pricing in six quarter-point rate cuts by the Fed. "We still see market

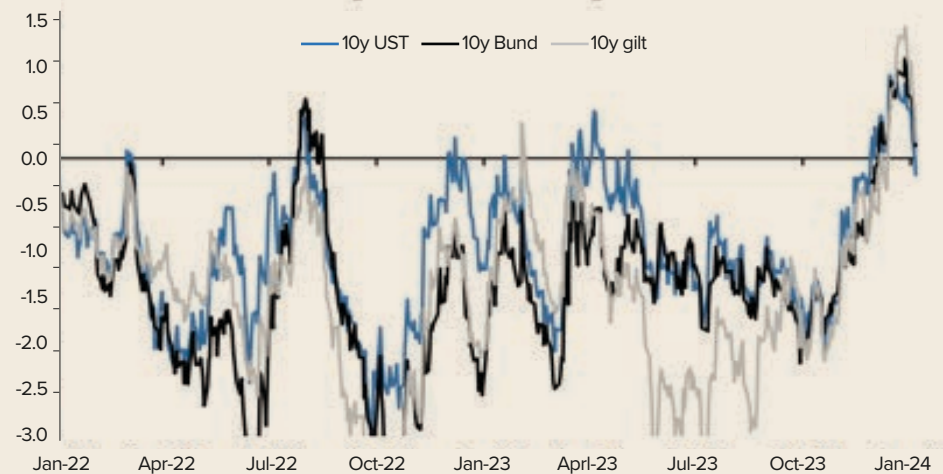
CHART 1: IMPLIED CASH ALLOCATION BY NON-BANK INVESTORS GLOBALLY



Source: Bank of America, Bloomberg

CHART 2: MOMENTUM SIGNALS FOR 10-YEAR SOVEREIGNS

Average z-score of short and long-term momentum signal



Source: JP Morgan, Bloomberg

CHART 3: S&P 500 PRICE VS. DECEMBER 2024 FED FUNDS RATE EXPECTATIONS



Source: BlackRock, LSEG

pricing of rate cuts as overdone given the inflation rollercoaster we expect, but the quick shift in expectations underscores the importance of managing macro risk as market narratives can suddenly flip flop,” she said.

This goes some way to explaining why investors allocated \$440m to the iShares \$ TIPS UCITS ETF (ITPS) between the turn of year and 19 January, according to data from Bloomberg Intelligence.

Speaking on the merits of inflation protection ETFs, Stephen Kemper, chief investment strategist, team advisory desk at BNP Paribas Wealth Management, said: “Investors could look to inflation protection, particularly in the US, which could be tempting in terms of not taking too much interest rate risk at this point.”

Alex Brandreth, CIO at Luna Investment Management, suggested combining inflation protection and short duration – by allocating to ETFs such as the iShares \$ TIPS 0-5 UCITS ETF (TIP5) – could offer “a positive real yield in the US, which is attractive”.

Equities less reticent

In equities, rate-sensitive small-caps have read the Treasury yield tea leaves, with the Russell 2000 index falling 1.5% in the year-to-date to 24 January. However, this has not carried across to US large caps, with the S&P 500 and Nasdaq 100 recently booking fresh all-time-highs.

Interestingly, by mid-January, the S&P 500 was 11% ahead of its price when the Fed began hiking rates in March 2022. The

headline US benchmark had also failed to respond to year-end Fed funds rate expectations creeping upwards, as it had done with two steep downticks in 2023.

From a technical perspective, JP Morgan also highlighted the proportions of outstanding shares of the SPDR S&P 500 ETF (SPY) and Invesco QQQ ETF (QQQ) being sold short at the start of 2024 were at their lowest since the arrival of COVID-19.

Looking to diversify away from market cap equity, Ahmer Tirmizi, head of fixed income strategy at 7IM, said the global healthcare sector represents an attractive defensive allocation.

“Earnings stability is more certain – and less connected to the economic cycle – valuations are attractive and it is coming off one of its worst runs of performance in decades,” he said.

Separately, while noting equal-weighting equities “hurt” last year amid artificial intelligence (AI) mania, Tirmizi suggested an equally weighted basket of US equities “has been a historically profitable investment strategy over time and especially at times like this”.

Unknowable unknowns

For market pundits, it is usually safer to be overly bearish and safe, rather than bullish and end up with egg on their face.

Interestingly, most are in lockstep in agreeing US inflation will not drift below 3% in the short-term. In fact, BlackRock’s Li said a long-term regime “closer to 3%” is one of her team’s “strongest views on a strategic horizon”.

Charlie Lloyd, head of investments at Skerritts, argued structurally higher inflation would be a likely outcome if the Fed were to enact the market implied rate cuts – bringing with it a new set of risks.

“Quelling a second wave of inflation would necessitate even tighter policy than is currently in place, putting recession back on the table,” he said.

Walking that tight rope is the job of policymakers – and responding to it the job of fund selectors – in the months ahead.

With 16 investment banks predicting up to 275bps of cuts starting in March, to 50bps of cuts from July, there are plenty of unknowns and moderation is key.

Jamie Gordon is senior features reporter at ETF Stream

ESG ETFs: Understanding the different approaches

The most important consideration for investors is which approach meets their own objectives

More than \$360bn assets are currently invested in ETFs classified by their issuers as ESG. But with more than 500 ESG ETFs launched over the past decade, how can investors find the ones most suitable to them? Here, we will explore and help define the broad range of ESG approaches.

Breaking down the jargon

This broad term “ESG” refers to a wide range of funds that consider environmental, social and corporate governance issues as part of their security selection and allocation methodology. The basic concept dates back over a century, but a more recent development has been in passive ETFs that follow ESG indices based on specific rules rather than an individual’s decision-making.

An ESG index is normally derived from a standard market-cap weighted index (the parent index). However, you can have two ESG indices constructed from the exact same universe of stocks, but they may be substantially different from each other due to the approaches they take.

ETFs that follow a strict “best in class” approach are the largest part of the ESG ETF market in terms of assets under management. However, “climate” ETFs gathered the most

assets in both 2022 and 2023. As we look at the different approaches, we will focus on the underlying indices being followed, as most ESG ETFs are passively managed.

Different approaches, different objectives

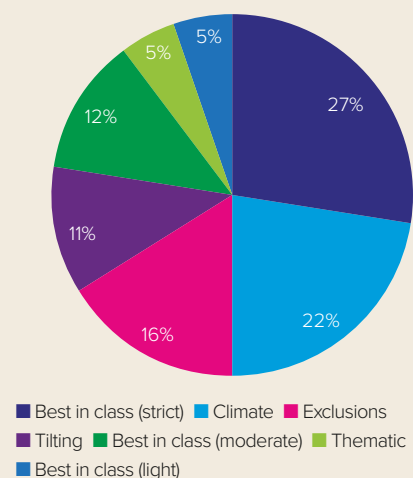
The first stage of constructing any ESG index will be to remove any securities of companies involved in what the index provider has defined as controversial activities or industries, normally including the likes of controversial weapons, coal and tobacco. As a general rule, the more securities that are removed, the more the ESG index performance is likely to deviate from that of the parent index.

Indices adopting an exclusions approach typically follow a two-step process:

1. Remove any securities from the parent index based on a business activity criteria;
2. Reweight the remaining securities (usually by their market capitalisation).

The intention of an exclusions approach is to construct an index profile like that of the parent index but without any securities considered unacceptable, as defined by the index provider in the index methodology. This type of approach will almost certainly lead to an index that includes securities

CHART 1: BROAD CATEGORY OF ESG APPROACH BY AUM



Source: Invesco, Bloomberg, as at 31 December 2023

with low ESG scores or that are involved in business activities that may be excluded by stricter ESG approaches. ETFs that follow an Exclusions-based index may be referred to as taking a “lighter-touch” ESG approach.

Indices adopting a tilting approach will also aim to provide similar characteristics as the parent index but with a methodology intended to improve the overall ESG score or other relevant metrics such as, for example, lowering carbon intensity. As mentioned, the first step in the approach taken by these indices will often be the same as for Exclusions:

1. Remove any securities from the parent index based on business activity criteria;
2. Apply a tilting factor to remaining securities based on ESG scores (usually relative to peers);
 - Increase weight of those with above-average scores;
 - Reduce weight of those with below-average scores.

The index methodology will define the targets and explain the mechanics of the tilting. The Tilting approach effectively rewards companies that are producing favourable ESG results and punishing those lagging behind.

Indices adopting a best-in-class approach are typically designed to focus on the companies exhibiting the highest ESG characteristics within their sectors, while totally excluding the lowest ESG performers. Again, the approach typically begins with exclusions:

“The ‘lightest’ best-in-class approaches may aim to capture around 75% of the parent index whereas the ‘strictest’ versions could aim to capture only the top 25% of the market weight, based on ESG scores”



1. Remove any securities from the parent index based on business activity criteria;
2. Remove all securities below a predefined threshold based on ESG score;
3. Reweight remaining securities according to index methodology, which may involve optimisation or some other techniques with the aim of reducing tracking error.

The performance of these indices could normally be expected to deviate more from their parent index than other ESG approaches, depending on how many constituents are removed.

The “lightest” best-in-class approaches may aim to capture around 75% of the parent index whereas the “strictest” versions could aim to capture only the top 25% of the market weight, based on ESG scores. The stricter the selection criteria, the more its performance is likely to deviate from the parent index.

Indices categorised as having a climate objective will generally adhere to the principles behind the EU’s regulatory framework for climate-related investment funds. The European Commission established the Paris-Aligned Benchmark (PAB) and Climate-Transition Benchmark (CTB) to provide investors with increased transparency into how indices that carry these designations plan on achieving their objectives related to greenhouse gas (GHG) emissions and the transition to a lower carbon economy.

- PAB indices are designed to meet the long-term goals of the Paris Agreement on climate change. A PAB index must have at least a 50% reduction in GHG emissions compared to its parent index and meet a 7% year-on-year reduction.
- CTB indices are considered to be less strict than PAB indices. For instance, a CTB index has different thresholds, such as a 30% minimum reduction in GHG emissions compared to its parent index (less than the PAB minimum of 50%).

Finally, thematic indices. These strategies differ as they’re more likely to be concentrated on a narrow part of the market rather than offering broad exposure. They will typically aim to capture those companies

that are contributing to or benefiting from a powerful, long-term trend.

Conclusion

Hopefully, this has provided you with a better understanding of the different approaches taken by the indices an ESG ETF may aim to follow. No approach is “better” or “worse” as each aims to fulfil different objectives. The most important consideration for investors is which approach meets their objectives, both in terms of ESG and financial performance. The next step is to find an ETF that can deliver that index performance as cost effectively as possible.

[Explore our range of ESG ETFs >>](#)

¹ Invesco, as at 31 December 2023

Investment risks

The value of investments, and any income from them, will fluctuate. This may partly be the result of changes in exchange rates. Investors may not get back the full amount invested.

Important information

Data as at 31.10.2023, unless otherwise stated. This is marketing material and not financial advice. It is not intended as a recommendation to buy or sell any particular asset class, security or strategy. Regulatory requirements that require impartiality of investment/investment strategy recommendations are therefore not applicable nor are any prohibitions to trade before publication. Views and opinions are based on current market conditions and are subject to change.

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What half the world voting means for ETF investors

‘Given the fraught political backdrop, we may see a more nervous market than what is currently priced’

By Jamie Gordon

Around four billion people heading to the polls does not just mark the most active year for democracy in history, it raises questions around volatility and how this will be priced in across fixed income, safe havens, single country and sector ETFs.

Hearing about general, regional and local elections across 70 countries may initially sound broad and intangible, but eight of the 10 most populous countries being among this cohort underlines the importance of 2024 for policymaking in years to come.

Aside from what the results mean for geopolitics and the accessibility of different markets, elections themselves also create the need for fund selectors to manage risk and dispersion within their portfolios.

“Irrespective of related changes to politics and policy, significant economic trends can impact market swings, making selective diversification and targeted country selection even more important for the new year,” Marcus Weyerer, senior ETF investment strategist, EMEA at Franklin Templeton, said.

James McManus, CIO at Nutmeg, noted almost as meaningful as who wins is the margin of victory, which dictates a government’s effectiveness.

“If the winning party fully controls the government – with a clear, working majority in the UK and taking both Houses and the White House in the US – they will have full sway to enact their legislative agenda. If power is split or there is no clear majority, we are more likely to experience a moderation of the policies of the winning party.”

Investors must also be mindful of ‘grey swans’ and allocating for uncertainties.

As said by former member of the House of Representatives Heather Wilson: “The only poll that matters is the one on election day.”

Developed markets

Delving into important considerations for a handful of this year’s ballot boxes, Weyerer noted presidential election outcomes tend to have “very little impact on market moves”, though the widest range of outcomes during the election cycle tend to occur in the 12 months preceding election day.

In the US, he said markets tend to post 17% volatility in years when the incumbent retains office and 20% in years where a new party enters the White House.

However, he warned: “Given the fraught political backdrop, we may see a more nervous market than what is currently priced.”

George Granville, partner at Courtville Partners, added politics will likely exert a “gravitational pull” over monetary and fiscal policy over the coming year. While he argued political pressure will not force the Federal Reserve to abandon its hawkish stance, a combination of no more rate hikes and “ultra-loose fiscal policy” means US financial conditions are as “pro-cyclical as it is possible to imagine”.

For ETF investors, former President Donald Trump’s recent polling and momentum in the caucuses will sound alarm bells ringing around the potential inflationary impact of

a renewed trade war following promises of a 10% tariff on all imported goods.

His “drill baby drill” remarks also point to a gear change from subsidies and tax breaks for clean energy projects and a shift in favour of expanded oil and gas production.

In the UK, FTSE Russell warned “sizeable rate cuts” are being priced in despite resilient wage and core inflation data as well as the Bank of England’s ‘higher for longer’ messaging.

“Fiscal easing ahead of the forthcoming UK general election may also delay lower rates,” the index provider warned, as Chancellor Jeremy Hunt looks to bolster support for the Conservatives with tax cuts ahead of voters heading to the polls in H2.

Russ Mould, investment director at AJ Bell, said data since the inception of the FTSE All-Shares illustrates UK equities “may even welcome” a change of party in office, with the index posting a “double-digit” gain on average in the year following a new party taking government.

“Inflation also sorts out the real winners and losers, from the markets’ perspective, when it comes to individual prime ministers,” Mould added. “Of the 13 prime ministers since 1962, four of the best five from the very narrow perspective of stock market returns were Conservatives, once FTSE All-Share returns are measured in nominal terms.”

For Europe, the gap between now and June contains several unknowns. At the time of writing, current European Commission President Ursula von der Leyen has not announced her candidacy for a second term in office, yet polls suggest she is the frontrunner.

According to Marion Muehlberger, senior economist at Deutsche Bank, a second term for the von der Leyen ‘grand centrist coalition’ is set against the backdrop of an “increasingly fragmented” European Parliament, with right-wing and Eurosceptic groups potentially claiming 20% of seats. Defence and implementing the EU Green Deal will also feature more prominently on the policy agenda, Muehlberger said.

Emerging markets

While the outcome of the US election will have far-reaching impacts across emerging economies, it is worth singling out a handful in focus for investors and political pundits.

First, Taiwan’s pro-sovereignty DPP led by President Lai Ching-te won a third consecutive term in office. Despite China sending

ELECTION CHEAT SHEET

Date	Election	Context
13 January	Taiwan presidential election	Lai Ching-te was voted President, marking a third consecutive term for the pro-sovereignty Democratic Progressive Party (DPP).
15-17 March	Russian Federation	Vladimir Putin is expected to retain office in Russia’s eighth presidential election. Opposition member Alexi Navalny remains imprisoned and barred from running.
April-May	India’s Lok Sabha election	The Bharatiya Janata Party (BJP) led by Narendra Modi took a clean sweep of December polling across Hindi belt states.
2 June	Mexican general election	President Andrews Manuel Lopez Obrador (AMLO) will leave office. His party, Morena, heads up a coalition which currently leads in the polls.
6-9 June	European Parliament election	The tenth election since the first direct election in 1979. Ursula von der Leyen expected to take a second term before announcing her candidacy.
6/27 October	Brazilian municipal elections	The first round of municipal elections are set to be held on 6 October, with a second round scheduled for 27 October, if necessary.
5 November	US presidential election	The election will appoint the next president, 435 members of the House of Representatives and 34 of 100 seats in the Senate. Donald Trump was favourite to return to the White House in six of ten recent national polls.
H2 2024	UK general election	An election will happen in the ‘second half’ of 2024. The Labour Party has a 16% poll lead as of 15 January.

“[In the UK], inflation also sorts out the real winners and losers, from the markets’ perspective”

24 planes and five boats into Taiwan’s air defence identification zone following the result, further escalation has yet to materialise.

Sekar Indran, senior portfolio manager at Titan Asset Management, noted potential opportunities in the “bottoming in the semiconductor cycle” and businesses such as TSMC trading on “attractive multiples”, however, he warned tensions with China “could overshadow these fundamental tailwinds”.

In India, Weyerer suggested incumbent Prime Minister Narendra Modi is on track for a third term with “a high approval rating following a pivotal year that showcased the country’s global ascendancy”.

Indran noted India has doubled its contribution to global growth since the pandemic of a purchasing power parity basis, but an increase in private capital expenditure and household expenditure are needed to lift corporate profits and drive equity returns higher.

Turning to Latin America, Indran suggested the “immense fiscal discipline and non-interventionist approach” of President

Andrés Manuel López Obrador (AMLO) should secure victory for a coalition led by his Moreno party, even after his departure.

He added ‘near-shoring’ could present a “multi-year opportunity” following two decades of “meagre growth”, though investors will be mindful of rallies in Mexican equities and the peso in 2023. AMLO’s term leaves scope for “more expansionary fiscal policy going forward”, he said.

Finally, while Brazil’s municipal elections are not expected to inspire the level unrest seen at the 2022 general election, they pose the risk of some short-term disruption to an otherwise positive outlook.

Indran noted tax reforms in 2023 would be a “large tailwind” for the economy, boosting growth and reducing litigation. Weyerer, meanwhile, said investors may find “an attractive entry point to this bright spot among global equity markets”, with a currency trading below its 10-year median on a real effective exchange rate basis.

Overall, while asset allocation should primarily be driven by strategic rather than tactical views, the year ahead presents no shortage of potential for new flashpoints in monetary policy, geopolitics and trade, that may be worth bracing for.

Jamie Gordon is senior features reporter at ETF Stream

Locking in yields

Bond yields have been on a rollercoaster ride over the past few years. As we look forward, we feel more confident that both short and long-term interest rates have peaked and that investors should take the opportunity to lock in yields on high-quality fixed income

Why did bond yields spike in 2023? One explanation was an apparent supply and demand mismatch in government bond markets, particularly for US Treasuries. With a considerable amount of US government spending already legislated for, the concern was that issuance of government debt would overwhelm bond demand now that the Federal Reserve is no longer buying Treasuries.

Bond vigilantes

At face value, this demand-supply mismatch has merit. Central banks absorbed a lot of the government debt issued in recent years and have committed to reducing their balance sheets. It is also true that in the absence of quantitative easing the bond market is 'free' to tell governments when it perceives spending programmes to be too much.

However, if private investors were worried about the uncontrollable profligacy of government spending, one might have expected the rise in yields to have been driven at least in part by higher inflation expectations. Instead, the move through the summer of 2023 was almost entirely driven by real yields.

The explanation for the move higher in bond yields that we find more compelling is that the US economy simply proved more

resilient to higher interest rates than was previously expected. Thus, the market has had to re-evaluate perceptions of what the sustainable or 'neutral' interest rate is.

Data in the driving seat

A combination of downside surprises on inflation and a softer tone from Federal Reserve officials pushed bond yields sharply lower in the last two months of 2023. The direction of yields from here will be driven by the economic data. If inflation proves frustratingly stubborn above 2% and the economy remains resilient, then some of the rate cuts that are currently priced may have to be removed, which could put upward pressure on yields.

If, however, the economy shows clearer signs of cracking under current policy rates, the pressure on central banks to cut rates will only intensify. This could send bond yields lower and potentially release a sizeable capital gain – a 200bp decline in the 10-year US Treasury yield over the next 12 months would result in a total return of 20%. In short, core bonds offer not only attractive income levels for investors but also potential capital gains in a recessionary scenario.

Being selective with fixed income

An element of selectivity will still be required. In Europe, we see the risk that some

“Demand for fixed income ESG ETFs is likely to remain strong, with two-thirds of Trackinsight’s survey respondents stating that fixed income ETFs can provide a good way to invest sustainably”



governments in the periphery will not be able to resist the temptation of expansionary fiscal policy in 2024. The 10-year bond yield spread between Italy and Germany is below 200bps. As a result, we think higher quality core European sovereigns look more attractive than their peripheral counterparts.

Globally, investors will also probably favour sovereign bond markets where monetary policy prospects are the most favourable. While in the US and Europe, we – like many other investors – believe that policy rates have peaked, this is not the case in Japan. With



the Bank of Japan set to normalise policy further in 2024, upward pressure on long-term Japanese bond yields looks set to remain.

Refinancing needs warrants a step up in quality

In corporate bond markets, both investment grade and high yield bond spreads have held in well this year thanks to a combination of relatively resilient growth and relatively little refinancing. The wall of refinancing to much higher interest rates is, however, coming. At face value it looks like 2024 ma-

turities should be perfectly manageable, but corporates tend to look a year ahead when assessing capital needs, making the step up in maturities in 2025 a problem that will need to be addressed in 2024.

The situation is likely to be more problematic in high yield than it is in investment grade. While imminent maturities in high yield markets are not as large as investment grade counterparts, the gap between the current coupon and index yield is wider, suggesting a bigger jump in interest costs when corporates have to issue debt at higher

rates. This outlook leaves us with a preference for investment grade over high yield, where total returns could also benefit from higher rate sensitivity if government bond yields start to fall.

Active fixed income ETFs to strengthen portfolios

The opportunity to lock in yields at current levels looks compelling, even if bond volatility is likely to remain elevated. This offers opportunities for active management and accordingly 56% of European ETF buyers surveyed in the recent ETF Pulse survey by ETF Stream and J.P. Morgan Asset Management think that 2024 will be the year for active management. Whether you are seeking yield, total return or stability, J.P. Morgan Asset Management is the largest active UCITS ETF provider, offering active fixed income ETFs across the global aggregate, credit, green, social and sustainable, and ultra-short income bond markets.

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Are the stars aligning for emerging market ETFs in 2024?

The emerging market recovery disappointed last year, but pockets of growth and key market indicators are pointing to positive signs for the asset class

By Theo Andrew

The emerging market recovery of 2023 may have underwhelmed in what was a strong year for global markets, but there are signs the stars could be aligning for the diverse asset class over the medium term.

One reason for its underperformance was China. The MSCI Emerging Markets index returned 9.8% in 2023 versus 20% for the MSCI Emerging Market ex-China index, as the world's second-largest economy continued to struggle.

However, investors are not willing to turn out the light on Chinese equities just yet. Mike Coop, CIO of Morningstar, believes investors are being "excessively pessimistic" about the country which could help drive broader emerging markets this year.

"The emergence of several EM ex-China ETFs recently is no coincidence, but even with its property market in the doldrums and lingering questions surrounding government stimulus, some investors believe there are positive signs"

"It is still an important economy and there are still some world class companies there," Coop said. "The government does not need the private sector to perform well for it to achieve its growth ambitions, so people should not write off its impact on broader emerging markets."

Emerging markets also have historical indicators on their side. The Bank of America's (BoA) proprietary global quant strategy 'Global Wave' turned positive in January and is often considered a precursor to a rally for global stocks.

In the year following previous troughs, emerging markets have outperformed US equities by an average of 3.1%, according to the bank.

Meanwhile, elections across some of the largest EM countries this year are likely to have a significant impact on markets. For



example, Argentina's stock market was up 20% following the election of pro-commerce Javier Milei.

The impact – along with question marks around the validity of emerging market benchmarks – is one of many reasons investors are getting increasingly granular in their exposure to emerging markets, with ETFs being one of the best ways to achieve this.

Hidden GEMs

The diversity of emerging markets has led to opportunities in different pockets of the asset class.

Despite its relative underperformance, seven of the top eight markets – 88% of the universe – posted positive returns, with six of them realising strong double-digit returns, according to fund house Ninety One.

One market that performed exceptionally well last year was Latin America, with the iShares MSCI EM Latin America UCITS ETF (LTAM) and the Amundi MSCI Emerg-



ing Markets Latin America UCITS ETF USD hedged (ALAG), returning 26.5% and 25%, respectively.

Much of this was powered by Brazilian equities, which experienced their best year since 2019. Despite a tough start to 2024 – the MSCI Brazil index is down 4.8% year to date – Alberto Garcia Fuentes, head of asset allocation at ACCI Capital Investments, believes macros could drive the market higher this year.

“The current landscape reflects the lagging repercussions of a previously restrictive economic environment,” he said. “But if a soft landing materialises, Latin America and Brazil stand to benefit from a weaker dollar.”

Coop added: “The concerns about the Brazilian politics and President Lula have not played out. You still have an attractive starting valuation, good quality assets and a beaten-up currency.”

Tax reform in the country has also proved to be a tailwind for the economy, boosting

productivity and reducing tax litigation, with loosening monetary policy also set to be a boon for equities, according to Sekar Indran, senior portfolio manager for equities at Titan Asset Management.

“Some of the good news is priced in following last year’s rally but equity valuations remain attractive,” he said. “High positive real rates give scope for looser monetary policy in 2024 which should also be supportive for its equity markets.”

Similarly, Mexican equities also had an extremely hot 2023, with the HSBC MSCI Mexico Capped UCITS ETF (HMEX) returning 40.3% last year, however, Fuentes believes recent onshoring trends could help the market deliver multi-year returns.

“The near-shoring trend has driven Mexico’s markets and the government is investing in capital expenditure to be able to cope with burgeoning demand,” he said.

Another, rather large, pocket of emerging markets is India. The world’s most populated

country has also been on a tear in 2023 but many fear it is overvalued.

“India does have some high-quality companies and has attracted a lot of attention of late and more positive expectations of how the economy might continue to grow,” Coop said. “The market is factoring in the good news and the question is whether the market has already baked in the price.”

However, Fuentes – who holds a slight overweight to India – believes robust private consumption and improving productivity means the market could be set to grow further. “There is a theme for digitalisation which can improve productivity, so we are positive on Indian growth.”

China bulls

China has gone from almost a third of the MSCI Emerging Market index to just over a quarter in the past 18 months as its poor performance continues to weigh on the broader index.

The emergence of several EM ex-China ETFs recently is no coincidence, but even with its property market in the doldrums and lingering questions surrounding government stimulus, some investors believe there are positive signs.

“There is rightful scepticism about the path the government is taking in dealing with the low growth environment, but as is usually the case this gets efficiently and rapidly priced in. We have taken a bigger position in China, reflecting just how much pessimism we have seen,” Coop said.

Government scrutiny over its home-grown tech sector has been the cause of much misery for Chinese tech stocks in recent years and while Indran still sees value in holding this exposure given its poor run, the group have recently sold down its position.

“Our main emerging market was Chinese internet companies where we are benchmark neutral, but we have been monitoring it closely given its weakness,” Indran said. “The Chinese equity market has had three years of consecutive declines and has never had four negative years in a row, but we need to see more meaningful stimulus to catalyse a turnaround.”

While the short-term outlook for China remains bumpy, a recovery would surely spark broad emerging market ETFs into life.

Theo Andrew is news editor of ETF Stream

Biodiversity funds: Welcome to the jungle in 2024

With a wide variety of terminology, there are diverse approaches to biodiversity investing, leading to a lack of harmonisation and making it harder for investors to navigate this area

By Rumi Mahmood and Shuang Guo

Investors have long been familiar with ESG and climate funds, which can encompass a wide variety of sustainability-linked themes and objectives. Following the UN's COP 15 Biodiversity Conference in December 2022 and the recent advent of the Taskforce on Nature-related Financial Disclosures (TNFD), biodiversity has emerged as an investment theme. The fund management industry has heard the call, and several biodiversity funds have sprung up in the past year.

A grassroots movement, for now

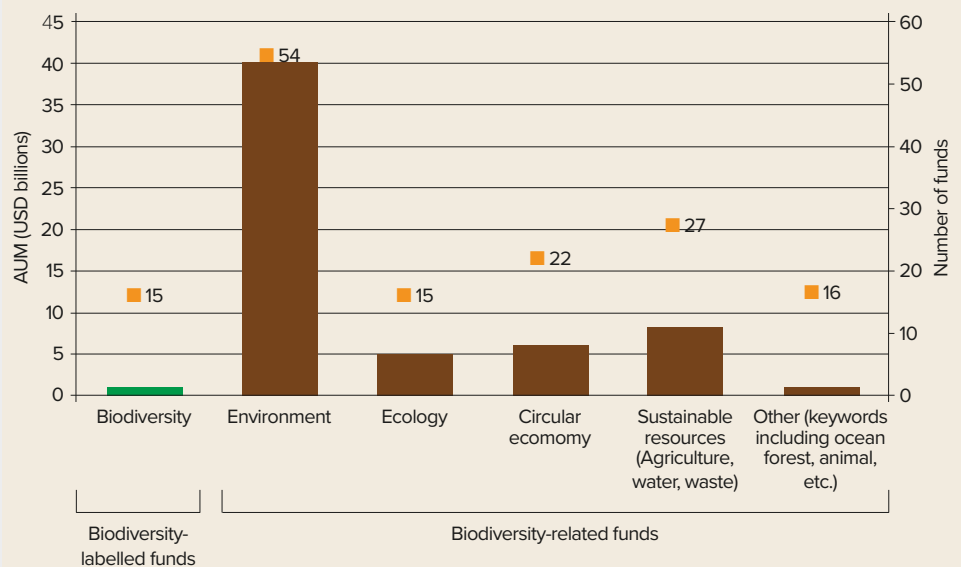
We identified 149 funds globally that are thematically linked to biodiversity based on the fund name and investment strategy. These funds collectively held approximately USD 60 billion, or around 2%, of the estimated \$3trn invested in sustainable funds as of September 2023.¹ Among these, there were 15 pure-play biodiversity-labelled funds with just over \$1bn AUM, the majority of which were mutual funds launched in 2022.²

The remaining funds were biodiversity-related with a broader environmental or associated thematic mandate such as strategies focusing on the circular economy that aim to provide exposure to firms that minimise waste, circulate resources, address water scarcity and regenerate nature.³

Beneath the foliage, exposure to industrials and IT dominated

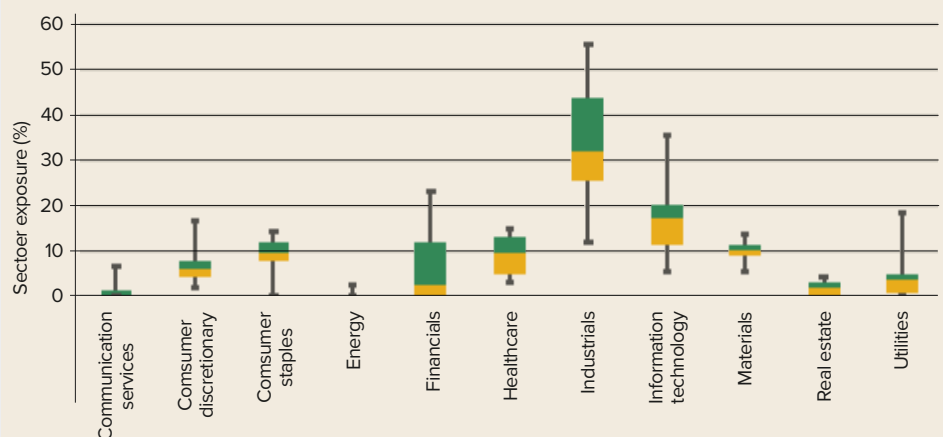
Zooming in on the 10 largest biodiversity-labelled funds based on AUM as of September 2023, we observed that cyclical sectors were dominant, with industrials on average accounting for the largest sector exposure,

CHART 1: THE CANOPY OF BIODIVERSITY FUNDS



Funds identified from MSCI's global coverage universe of mutual funds and ETFs. Number of biodiversity-labelled funds: 15, biodiversity-related funds: 134. Source: MSCI ESG Research as of Sept. 14, 2023.

CHART 2: CYCLICAL SECTORS FAVOURED IN BIODIVERSITY-LABELLED FUNDS



The green and yellow bar represents the distribution and quartiles of funds' Global Industry Classification Standard (GICS®) sector exposures in percent, the mid-line between is the median. (GICS® is the global industry classification standard jointly developed by MSCI and S&P Global Market Intelligence.) The error bars represent the minimum and maximum GICS sector exposures in percent. Source: MSCI ESG Research as of Sept. 14, 2023.

Nature-related risks and opportunities are becoming more important for investors and regulators²

followed by information technology and materials, with virtually no exposure to energy.⁴

Money doesn't grow on trees— lower risk-adjusted returns vs. peers

In recent years, biodiversity-labelled funds have, on average, delivered lower risk-adjusted returns versus their peers in the same thematic sphere. This may partly be attributed to the large allocation to cyclical sectors, in particular information technology, which experienced a series of sharp selloffs in 2022. That being said, the lower correlation to other sustainability themes may serve as a diversifying function for investors. Based on our research, however, asset-class diversification may be a challenge at present, with over 90% of funds being equity strategies focused on developed markets.

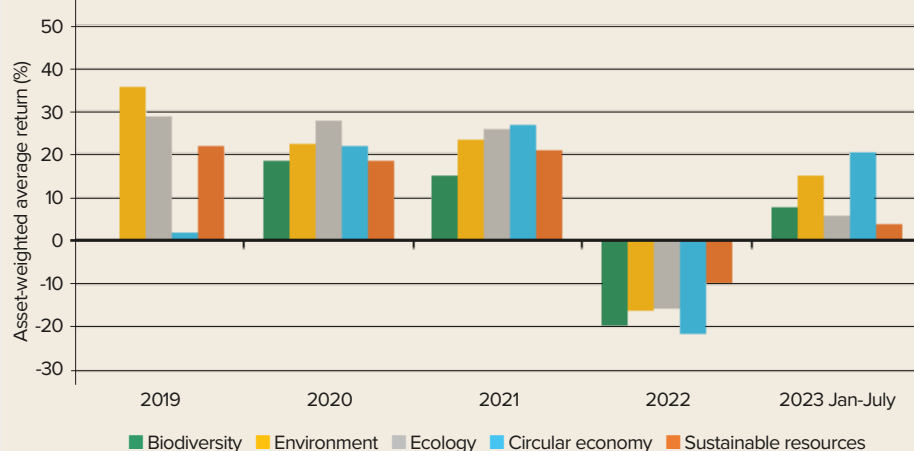
Fruits of labour – higher exposure to sustainable impact solutions vs peers

Using MSCI Sustainable Impact Metrics, we found that, on average, funds that contained the term “biodiversity” in the name exhibited twice the sustainable-impact-solutions revenue exposure as their biodiversity-related peers. These funds had more exposure to companies that derive revenue from products or services with positive impact on society and the environment, and revenue tied to natural capital and climate change themes.

Navigating the jungle

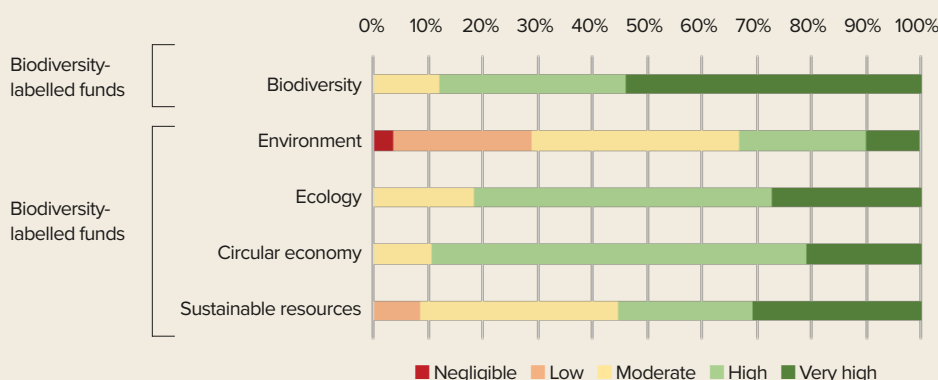
Overall, biodiversity remains a nascent investment segment, with only a limited number of funds explicitly adopting biodiversity as the core investment theme. Investors may be confronted with a broad mix of different strategies and investment approaches that can vary significantly in terms of their level of complexity and their clear link to global biodiversity goals. They may range from funds

CHART 3: ASSET-WEIGHTED AVERAGE RETURNS OF BIODIVERSITY-LABELLED AND -RELATED FUNDS BY CALENDAR YEAR



Number of biodiversity-labelled funds: 15, biodiversity-related funds: 134. Asset-weighted performance per calendar year. Biodiversity-labelled funds did not exist prior to 2020 in our sample from MSCI's standard coverage universe. Source: MSCI ESG Research as of Sept. 14, 2023.

CHART 4: EXPOSURE OF FUNDS TO SUSTAINABLE-IMPACT SOLUTIONS



Number of biodiversity-labelled funds: 15, biodiversity-related funds: 134. Source: MSCI ESG Research as of Sept. 14, 2023.

based on exclusion criteria, to ones that apply sophisticated metrics with a clear focus on businesses aligned with global biodiversity goals. Hence, understanding the finer details of biodiversity-labelled funds may be key for investors to successfully navigate this space.

Nonetheless, nature-related risks and opportunities are becoming more important for investors and regulators, and coupled with the emergence of reporting frameworks such as TNFD, biodiversity funds may soon receive greater attention.

Rumi Mahmood is head of ESG and climate fund research, and **Shuang Guo** is ESG and climate fund analyst at MSCI

¹ Sustainable funds are defined as any fund that employs any ESG, climate or other sustainability-related considerations in its investment process (values and screening/ranking/exclusions/integration/optimization, etc. and their combinations). In simplest terms, it is the widest possible net under which any and all funds employing any sustainability considerations in security selection are captured, based on the fund prospectus and regulatory filings including claims of focus on sustainability, impact or ESG factors. All fund characterizations based on data from MSCI ESG Research, as of Sept. 14, 2023.

² Biodiversity-labelled funds are funds with the term “biodiversity” in the fund name, prospectus and investment strategy.

³ Biodiversity-related are funds identified by keywords thematically linked to biodiversity such as environment, ecology, sustainable resources or circular economy in the fund name, prospectus and investment strategy.

⁴ The financial performance of cyclical sectors fluctuate in tandem with macroeconomic conditions and business cycles.





Fund selectors reveal biggest risks for 2024

Higher-for-longer interest rates and a spike in inflation, investors assess their biggest risks to markets in 2024

By Theo Andrew

‘Careful what you wish for’ could be one of the most important mottos for professional investor rebalancing their portfolios for 2024. The equity and bond market rally that encapsulated the final two months of last year has left markets wondering if there could be a reckoning on the cards.

Last December, Wall Street analysts were forecasting no less than six interest rate reductions throughout 2024 – a potentially 150 basis point cut from 5.50% to 4% – as investors banked on the Federal Reserve successfully engineering a soft, or no, landing.

While markets have rowed back somewhat on this bullish outlook, investors have been left assessing the market dynamics of such aggressive rate cuts as they look to hedge against the risks of overexuberance at the end of last year.

“I would say be careful what you wish for,” Stephen Kemper, chief investment strategist, team advisory desk at BNP Paribas Wealth Management, told *ETF Stream*. “If we see six rate cuts in Europe and the US in 2024, it is because we have a recession.

“I am not sure the market would enjoy such as scenario so that for me is one of the biggest risks.”

An equally worrying prospect for investors is the idea that central banks will keep rates higher for longer – as inflationary pressures linger – which risks tipping major economies into recession.

In addition, heightened geopolitical tensions and several key elections means there are plenty for fund selectors to be wary of in 2024.

No landing vs recession

Despite sounding like the ideal scenario for portfolios, the prospect of a ‘no landing’ in the US poses risks for investors.

Dimas Cuevas Izaguirre, portfolio manager at Sabadell Urquijo, believes this would result in “transitory disinflation”, the idea inflation could rise sharply again on the back of an economic rebound.

“If this scenario comes to fruition, the consequences could be an unexpected surge in inflation, delayed rate cuts, and increased volatility in both equity and bond markets,” he said. “The Fed is delicately balancing its responsibility to maintain price stability

“If we see six rate cuts in Europe and the US in 2024, it is because we have a recession. I am not sure the market would enjoy such as scenario so that for me is one of the biggest risks.”

“With Trump and Biden offering very different visions for America, the election could have meaningful consequences for the global economy, particularly given what is happening in the Middle East and Ukraine where there is a risk of escalation”

and promote full employment, suggesting that we cannot signal the all clear just yet.”

Historically, the last mile of disinflation – from 4% to 2% – has been the most challenging and many believe it will not be achievable without a recession across major economies.

“A significant slowdown or a recession in the US this year is not currently priced in to equity markets,” Jack Byerley, collective portfolio service manager at Verso Investment Management, said.

“Almost a record number of people are expecting the US to avoid a recession, of which there is no historical precedent. A US recession could have a big hit on earnings and that is the biggest risk to equity markets currently.”

Despite this, US economic data continues to be strong, following a sizable gain in retail sales in December 2023, a bounce in consumer confidence in January and a fall in jobless claims to an 18-month low.

Meanwhile, the S&P 500 hit an all-time high in January as it broke above its previous January 2022 peak, driven by hopes for substantial rate cuts, exacerbating fears the Fed could leave rates higher for longer.

Investors have been wary of this overconcentration, however, with equally weighted ETFs proving to be one of the most popular allocations in the second half of last year.

Peter McLean, director of investment strategy research at Stonehage Fleming, said his base case is the Fed will achieve a ‘soft landing’ but noted how the central bank is still walking a tightrope with monetary policy.

“The challenge for the Fed is to recalibrate their policy cleverly to land the plane smoothly,” he said. “There could be a situation where interest rates are cut too slowly and policy remains too restrictive for too long, tipping the economy into recession. Or, they could cut too quickly and reignite inflation domestically.”

In a bid to hedge against a recession, McLean said the group had been upping its

US Treasuries exposure with 10 years returning around 4%.

“If we do have a recession, yields are very likely to push lower and that means you have the lift in capital value as well as the ongoing income.”

Geopolitical risks

Alongside the risk of a recession keeping interest rates higher for longer, the prospect of rising geopolitical tensions could cause inflation to edge upwards.

The Russia-Ukraine war has already reshaped global commodity markets and increased uncertainty in the Middle East, impacting oil prices and influencing market sentiment further.

“The biggest geopolitical risk is that we get a spike in inflation as more countries get dragged into the Israel-Palestine conflict,” Byerley warned. “The Middle East is increasingly fluid and volatile and that is where the biggest geopolitical risk is.”

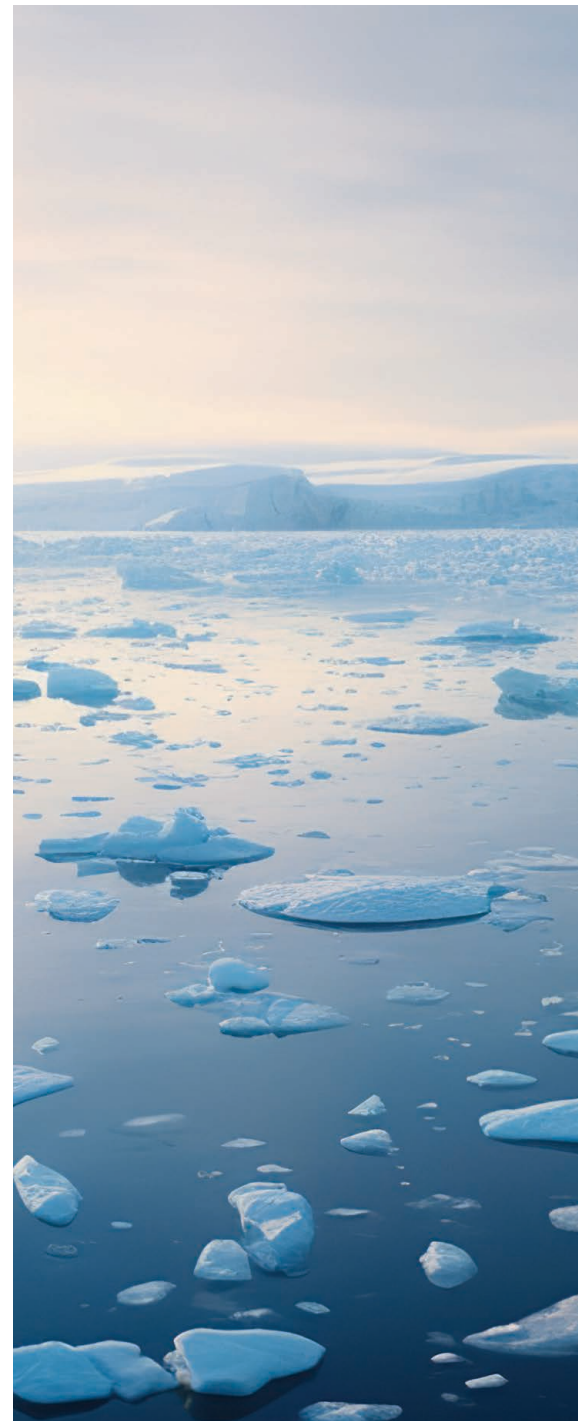
Kemper added the attacks on global trade by Houthi rebels in the Red Sea could create a supply train bottleneck and a subsequent rise in inflation.

“We saw during COVID-19 how quickly things can get nasty. It is not my high conviction, but central banks may have to go from cutting rates to hiking again and it is certainly an area investors need to keep an eye on,” Kemper said.

As a result, he has been shortening duration risk in case rates stay higher-for-longer and added Treasury Inflation-Protected Securities (TIPS) could be another option for investors concerned about rising inflation.

“We felt the moves down in the yields at the long end of the curve were a bit overdone so we are reasonably short duration,” he said.

Echoing his views, McLean said rising tensions in the Middle East “could have a meaningful impact on global inflation”.



“If we do have a scenario where inflation rises very suddenly or unexpectedly, the Fed may need to raise interest rates further,” McLean continued. “The scenario really is the worst one because markets will behave like 2022 with bonds and equities going down.”

He said the group has been balancing its portfolios with alternatives, physical gold and insurance-linked bonds to defend against the prospect of rising inflation.

Trump volatility

How much of these geopolitical risks will play out in 2024 and beyond will largely be



down to who is in power. With over half of the world's population set to hit the polls throughout the year, all eyes will be firmly focused on the US presidential election, most likely between Donald Trump and Joe Biden.

McLean argued the election cycle colliding with geopolitical risks is likely to lead to heightened volatility in markets as the year progresses.

"With Trump and Biden offering very different visions for America, the election could have meaningful consequences for the global economy, particularly given what is

happening in the Middle East and Ukraine where there is a risk of escalation," he said.

Despite this, Byerley argued much of the volatility this year will be a result of monetary policy and other geopolitical tensions rather than uncertainties around the election.

"Any election-linked volatility, if it does occur, would likely be post-election once the market has digested the result."

Instead of posing a risk to markets, Izaguirre views the US election as an opportunity to increase the group's equity allocation.

"Our strategy is dynamic, and as the year progresses, a carefully planned shift towards

a more risk-on position in equities could be implemented if the opportunity arises," he said. "Historical data indicating favourable market conditions in US election years provides a strategic rationale for this anticipated shift.

"Most often, the best hedge against market uncertainties is to 'keep a cool head' and hold a diversified portfolio of assets, adding to it as opportunities arise. Recent experiences in 2022 and 2023 confirm the effectiveness of this approach."

Theo Andrew is news editor at ETF Stream

Beyond Beta

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Is yield curve normalisation still on the cards?

Lack of clarity on the Fed's terminal rate creates doubt about where yields will settle

By Althea Spinuzzi

Volatility in bond markets is likely to remain elevated throughout the year as markets bet on an aggressive interest rate-cutting cycle, but central banks remain concerned about a possible rebound in inflation.

Within this environment, we remain cautious and favour sovereign bonds over investment-grade and high-yield corporate bonds.

Corporate bond spreads will likely widen as they are within their 2010-2020 average despite the highest policy rates in more than 20 years and economic activity deteriorating. On the other hand, sovereign bonds offer enticing returns while offering upside in case of a market downturn.

According to the Bloomberg US Treasury Total Return index, US Treasuries have provided negative returns for only six years from 1972 until today. Two of those years were 2021 and 2022 when inflation ran multiples of the Federal Reserve's 2% inflation target.

As inflation gets closer to the Fed's target, interest rate cuts are warranted, inducing a bull-steepening of the US yield curve as it normalises, setting the ground for investors to extend their portfolio's duration.

Yet, the biggest risk that bond investors

are facing is that the Federal Reserve might not cut interest rates close to zero, a level markets have been accustomed to since the 2008 Global Financial Crisis.

Three potential landings

The big question is what will happen to the longer part of the yield curve once central banks cut rates. When answering this question, it is impossible not to enter into a heated debate regarding some sort of landing:

- 1. A 'soft landing':** such a scenario implies that inflation reverts to its mean without a significant deceleration of the economy. In this case, the yield curve will bull steepen, but without a recession, the long part of the yield curve will remain around current levels or even move slightly higher.
- 2. A 'hard landing':** such a scenario implies a deep recession is upon us. That means the Federal Reserve might need to cut rates deeply and quickly. That would result in a steeper curve, with 10-year yields dropping sharply below 4%.
- 3. A '70s landing':** the fight against inflation is not over, and as geopolitical tensions intensify, inflation rebounds, resulting in a new inflation wave. Yet the economy stagnates, resulting in a flatter yield curve.

The risk is that the Federal Reserve may halt interest rate cuts due to a rebound in inflation and the benchmark rate stabilises above market expectations



Although it is impossible to know which kind of landing we are headed towards, it is essential to recognise that the Fed can stimulate the economy through various policies beyond interest rate cuts, such as a slowdown or the early end of the quantitative tightening programme (QT).

QT is a powerful tool because it can be a substitute for interest rate cuts. Therefore, if a 'hard landing' does not materialise, bond futures must price out some of the six rate cuts that are baked in for this year.

Moreover, we must remember that the US Treasury is poised to continue issuing large



amounts of bonds and notes in the upcoming months, putting upward pressure on rates.

That means that if a recession is not around the corner and the economy continues to prove resilient, 10-year yields are more likely to move higher than lower in the upcoming weeks. That is probably why Bill Gross, in a recent tweet, said “UST 10-year at 4% is overvalued while 10-year TIP at 1.80% is the better choice. If you need to buy bonds. I do not.”

Bond futures are currently pricing the Fed Fund rate not to drop below 3.5% throughout the next ten years. If that were to hold, it

would have implications for the longer part of the yield curve.

Stubborn inflation?

Historically, 10-year US Treasuries have paid around 100 bps over the Fed fund rate. Therefore, if interest rates do not fall below 3.5%, it would be prudent to consider a 10-year US Treasury to stabilize around a 4.5% yield.

The risk is that the Federal Reserve may halt interest rate cuts due to a rebound in inflation and the benchmark rate stabilises above market expectations. Therefore, 10-year yields might stabilise much higher than

where they are trading today. Yet, it is too early to consider such a scenario.

Throughout the year’s first part, we expect deflationary pressures to justify an aggressive interest rate-cutting cycle supporting sovereign bonds across tenors. Only in the second part of the year will it be possible to observe whether inflation remains a threat. If it does not, the bond bull rally is likely to extend.



Althea Spinozzi is senior fixed income strategist at Saxo Bank



Breakfast workshop

The evolving role of an exchange in trading ETFs

The growth of request-for-quote trading has led exchanges to rethink their offering

The growing dominance of request-for-quote (RFQ) trading within ETFs is leading many exchanges to evolve their offering in a bid to keep their market share.

Speaking at a recent ETF Stream Breakfast Workshop, Adam Sherlock, head of equity sales Europe at SIX Swiss Exchange, said de-

spite a 50% increase in overall ETF turnover over the past five years, the industry could do more to optimise ETF trading in Europe.

This is one of the key drivers behind SIX's decision to become the first exchange to offer pan-European ETF trading on its on-exchange RFQ platform – ETF Quote-on-Demand (QoD) Europe – last December.

“The daily ETF value traded over the past five years has – in periods of volatility and spikes – experienced more like 100% growth”, Sherlock said.

“However, on-exchange turnover has remained relatively stable during this period, in the high €30-40bn per month. The real winners are RFQ platforms which have been vacuuming up much of this growth.

“There are ways we can optimise ETF trading in Europe today and as an industry, do better.”

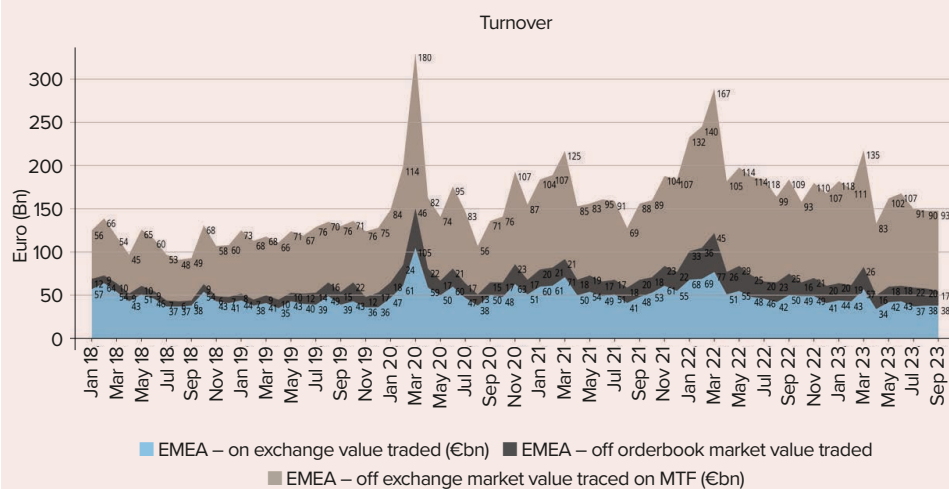
Closing the gap

While ETF trading is primarily executed via RFQ or on exchange, Sherlock believes the industry should look towards the more sophisticated practice of equity trading in a bid to increase trading options.

“Equity trading prides itself on navigating market complexity, using a sophisticated and diverse mix of mechanisms,” he said. “In contrast, trading an ETF is much more simplistic, often a decision made at firm level and more commonly being made in favour of RFQ.”



CHART 1: ON EXCHANGE VS RFQ



“The growing momentum around the use of algorithms in ETF execution is a big step in the right direction from our perspective”

Adam Sherlock, SIX Swiss Exchange

“At SIX, we are trying to close the gap between the asset class of equities, not pushing complexity for the sake of it, but by taking a hybrid approach and leveraging the best of different mechanisms through data-driven decision making.”

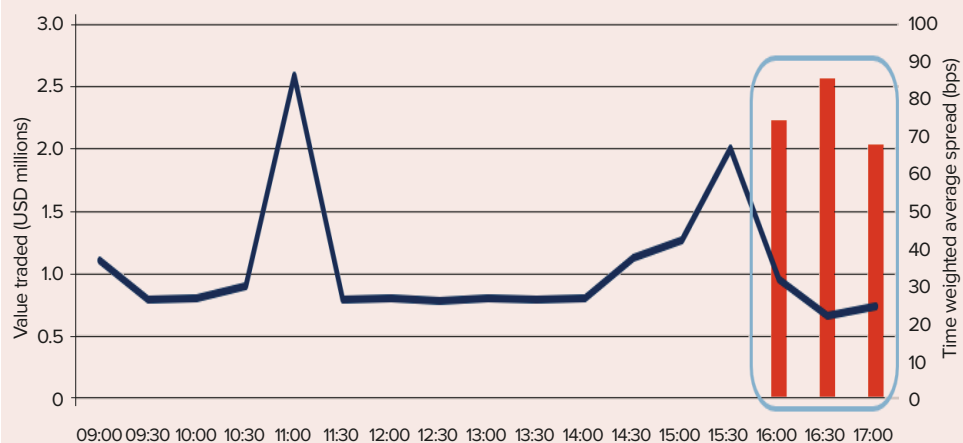
Sherlock also noted ‘lit’ order books in ETFs do not behave as they do in other asset classes, but can absorb “much more volume” than many give them credit for when put through a liquidity stress test.

Sherlock drew on the example of October 2023 to show liquidity absorption ability of the lit order book: Of the 1,700 ETFs listed with SIX Swiss Exchange, more than 10% of them had at least a single trading day where their lit turnover exceeded the average daily value traded (ADVT) by more than 10 times. One example, the Amundi MSCI Emerging Markets UCITSETF (AEEM) traded 24 times its ADVT in just the last 90 minutes of the trading day on SIX.

“This had no meaningful impact on pricing. In fact, the spreads were the tightest in that window than over the entire daily period,”



CHART 2: OUTSIZED LIQUIDITY ON LIT BOOKS



Sherlock said. “That suggests there is meaningful natural buy and sell liquidity in the most liquid European ETF names that should have the opportunity to meet each other.”

The rise of algos

Sherlock said ‘lit’ order books give greater flexibility in the time horizon in which a trade is executed while a “point in time trade” via RFQ runs the risk-reward of executing at both a favourable and unfavourable price.

“RFQ does not allow passive liquidity capture in a liquid ETF with plenty of natural

liquidity. Trading should combine passive liquidity capture with opportunistic spread crossing behaviours,” he said.

“The growing momentum around the use of algorithms in ETF execution is a big step in the right direction from our perspective.”

Despite this, he noted ETF-specific algos “which respect their bespoke market structure” was the way forward as opposed to using an equities algo “in the hope for great outcomes”.

SIX Swiss Exchange’s QoD platform enables buy-side dealers to trade ETFs on other primary exchanges, bringing the number

of ETFs available to trade to approximately 6,000, up from 1,700 currently listed on the exchange.

“With QoD Europe, we are working to improve the choice that either a trader or an algo has when deciding to trade an ETF on a pan-European basis,” Sherlock said.

He added the platform’s “sweet spot” was mid-sized trades, noting a >20% price improvement over primary liquidity prices.

“We believe there is space for these workflows to support the intelligent integration into decision-making and maximising the role they play in the execution of ETFs,” Sherlock said.

ETF QOD Europe

The novel service ETF QOD Europe offered by SIX represents an extension of the existing Exchange Traded Funds (ETF) franchise. In addition to over 1,700 tradable products listed at SIX Swiss Exchange, trading participants are now able to trade ETFs listed on other primary exchanges like the London Stock Exchange, Euronext Amsterdam, Euronext Brussels, Euronext Paris, Deutsche Börse XETRA, Borsa Italiana, Wiener Börse AG or Nasdaq Stockholm AB.

This innovative trading service offers efficient straight-through processing using the interoperable Central Counterparty (CCP) model with settlement into domestic Central Security Depositories (CSDs). This service-extension positions SIX as leading primary regulated exchange operator offering the biggest ETF product universe: approx. 6,000 ETFs and ETPs are tradable on its on-exchange Request for Quote (RFQ)-platform QOD, making SIX the first exchange operator to offer pan-European on-exchange RFQ Trading for ETFs. <https://www.six-group.com/etfcodeurope>



Data dashboard: January 2024

Investors once again moved into short duration ETFs in January as they rowed back on the number of Federal Reserve’s interest rate cuts in 2024

Data provided by



Data as at 23 January

TOP PERFORMANCE

Ticker Return

TOP 10 BEST PERFORMING ETFS

Sprott Uranium Miners	URNM	16.96
Global X Uranium UCITS ETF	URNU	12.33
Global X Uranium UCITS ETF - USD (DIST)	URNG	11.72
VanEck Uranium and Nuclear Technologies	NUCL	8.50
Amundi MSCI Semiconductors ESG Screened	CHIP	6.76
Amundi MSCI Semiconductors ESG Screened	TWAN	6.76
iShares Nikkei 225	CNKY	6.53
iShares Nikkei 225®	EXX7	6.53
Amundi S&P Gbl Information Tech ESG UCITS ETF DR - EUR (A)	MWOB	6.37
Amundi S&P Gbl Information Tech ESG UCITS ETF DR - EUR (D)	WELL	6.37

TOP 10 WORST PERFORMING ETFS

Melanieon BTC Equities Universe	BTC	-28.77
Global X Blockchain	BKCH	-28.64
VanEck Crypto and Blockchain Innovators	DAPP	-27.06
WisdomTree Blockchain	BKCN	-22.94
iShares Blockchain Technology	BLKC	-22.83
Grayscale Future of Finance	GFOF	-22.46
Global X Hydrogen	HYGN	-20.92
ETC Group Digital Assets and Blockchain Equity	KOIP	-19.75
VanEck Rare Earth and Strategic Metals	REGB	-18.47
Invesco Solar Energy	RAY5	-17.33

INFLOWS

OUTFLOWS

Name	Ticker	Inflows (\$m)
iShares Core € Corp Bond	IEAC	2,058.05
iShares Core S&P 500	CSPX	1,693.12
iShares Core MSCI World	SWDA	809.22
Vanguard S&P 500	VUSA	777.40
iShares \$ Tips	ITPS	478.55
Xtrackers S&P 500 Swap	XSPU	390.02
iShares € Govt Bond 1-3yr	IGBS	343.69
Xtrackers II EUR Overnight Rate Swap	XEON	337.70
Xtrackers MSCI World Health Care	XDWH	287.05
iShares MSCI Japan ESG Enhanced	EEJD	263.52

Name	Ticker	Outflows (\$m)
iShares MSCI Emu Esg Enhanced	EMUD	-454.08
iShares \$ Corp Bond	LQDE	-370.33
Pimco Euro Short Maturity	PJSR	-304.56
Ishares \$ Treasury Bond 20+Yr	IDTL	-294.47
Xtrackers S&P 500 Swap	XSPU	-288.28
UBS (Lux) Fund Solutions – MSCI EMU Socially Resp	EMUSRI	-266.36
Invesco S&P 500	SPXS	-246.07
iShares J.P. Morgan \$ Em Bond	SEMB	-231.45
Amundi Index MSCI Em Asia SRI PAB	SADA	-186.99
Amundi MSCI World ESG CTB Net Zero Ambition	LWCR	-182.09

NEW LISTINGS

Name	Fund ISIN
VIRTUNE ARBITRUM ETP	VIRARBSS
VIRTUNE STAKED POLKADOT ETP	VIRDOTSS
ISHARES MSCI USA ESG ENHANCED UCITS ETF - GBP HEDGED (DIST)	EDMGLN
VANECK MORNINGSTAR US WIDE MOAT UCITS ETF	WMOTGY
VANECK MORNINGSTAR US SMID MOAT UCITS ETF	SMTVGY
AMUNDI MSCI WORLD UCITS ETF DR - USD (C)	WRDUNMM
AMUNDI MSCI WORLD SRI CLIMATE NET ZERO AMBITION PAB UCITS ETF ACC EUR HEDGED	MWSHGY
AMUNDI MSCI WORLD SRI CLIMATE NET ZERO AMBITION PAB UCITS ETF ACC	WSRIINMM
ISHARES \$ SUKUK UCITS ETF USD (DIST)	SKUK



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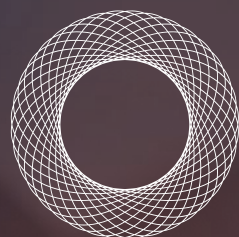
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