

ETF Insider

DECEMBER 2023 | EUROPE'S LEADING ETF MAGAZINE FOR PROFESSIONAL INVESTORS

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The problem of choice

Welcome to the Winter 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 focuses on the ESG ETF landscape in Europe, an area of the market that continues to attract inflows, albeit at a slower pace versus the last two years. According to data from Morningstar, ESG ETF inflows accounted for just 25.6% – €7.3bn – of all flows into European-listed ETPs in Q3, a far cry away from the 50+% inflows seen in 2021 and 2022. Despite the lower inflows, ETF issuers still view the area as a key way to differentiate from competitors. Sustainable ETFs have tripled over the past five years and now total 592, up from 187 at the start of 2018. How to navigate this landscape is one of the focuses of this issue (p.34) as fund selectors grapple with the myriad of options available – select, leaders, elite, Paris-aligned, climate transition, net zero and socially responsible, to name a few.

Understanding these labels is crucial for fund selectors if they want their portfolios to have the desired performance and impact (p.22). The performance dispersion across S&P 500 ESG UCITS ETFs this year has been 7.8%, as at 22 November, with the best ETF returning 23% versus 15.2% for the worst performing, according to data from Bloomberg Intelligence. While choice is always welcomed by fund selectors, extra due diligence is required when incorporating ESG ETFs in portfolios.

Elsewhere, keep an eye out for fantastic analysis on why diversification may not be the free lunch everyone thinks it is from Parala Capital's Reza Vishkai (p.44) and a deep dive into active ETFs and China from ETF Buyers Club members Edoardo Mezza (p.46) and Karin and Stefan Wiederkehr (p.48) as well as the usual 'Education Corner' (p.13), 'ETF of the month' (p.14) and 'Fund Fights', where *ETF Stream* compares the strengths and weaknesses of similar ETFs (p.15). Finally, I want to highlight our Expert Investors series where *ETF Stream* interviews fund selectors about their asset allocation and ETF usage (p.12).

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News & views

All the highlights from the last month, for all the latest updates visit [etfstream.com](https://www.etfstream.com)



The fierce price war in ESG ETFs

SSGA cut fees on its ESG ETF to 0.03%

By Tom Eckett

ESG is not an area of the market that typically gets associated with fee wars, however, ETF issuers have been making aggressive cuts in recent months, a boon for fund selectors.

The latest cuts came in October when State Street Global Advisors (SSGA) reduced the total expense ratio (TER) on its S&P 500 ESG ETF, the SPDR S&P 500 ESG Leaders UCITS ETF (SPPY), from 0.10% to 0.03%.

SPPY is now the cheapest ESG ETF of any shade of green on the European market, ahead of JP Morgan Asset Management's research enhanced fixed income ESG ETFs by one basis point. The ETF tracks the S&P 500 ESG Leaders index which adopts stricter criteria versus

the S&P 500 ESG index to offer exposure to a basket of 208 securities.

Other ETF issuers have been equally as aggressive in their positioning of ESG ETFs that track broad market-cap weighted benchmarks. Interestingly, this is taking place across all flavours of ESG.

The Franklin S&P 500 Paris Aligned Climate UCITS ETF, for example, charges 0.07%, the same TER as BlackRock's US enhanced ESG ETF and Amundi's US climate ETF.

Because these strategies are relatively straightforward in their construction, ETF issuers feel they need to be competitive from a pricing perspective and are prepared to match the fees of plain vanilla passive ETFs.

There are some ETF issuers that are yet to react to their rivals, however, investors

will vote with their assets and have always gone for the cheaper product as highlighted by the €1bn inflows into the SPDR S&P 500 UCITS ETF (SPY5) since its TER was slashed to 0.03%.

Trading costs

Spreads on ESG ETFs have also narrowed significantly in recent years as assets in the strategies have grown, however, some remain significantly wider than their passive counterparts.

The UBS ETF S&P 500 ESG UCITS ETF (S5ESG), which has €1.9bn AUM, has an average bid-ask spread of 0.20%, according to data from Bloomberg Intelligence.

Despite the reduction in fees, fund selectors are hampered by the spreads on some ESG ETFs, affecting total cost of ownership across ESG portfolios.

However, the largest ESG ETF in Europe, the €7.1bn iShares MSCI USA SRI UCITS ETF (SUAS), has an average bid-ask spread of 0.08%, highlighting how ESG ETFs are becoming more liquid.

“Fed chair Jerome Powell has significantly toned down his hawkish rhetoric by signalling the US central bank will hold rates at the next Federal Open Market Committee (FOMC) meeting on 1 November”

Final word

Overall, fee cuts are only positive for investors and ETF issuers must react to moves made by rivals or risk being left behind.

Tom Eckett is editor of ETF Stream

Dateline: The month in review

1 November

DWS drops Deutsche Bank for Solactive on overnight rate swap ETF range

DWS's popular overnight rate swap ETF saw its index provider swapped from Deutsche Boerse to Solactive in a bid to broaden the number of available swap counterparties. The Xtrackers EUR Overnight Rate Swap UCITS ETF (XEON) – which recorded \$1.3bn inflows in Q3 – went from tracking the Deutsche Bank Euro Overnight Rate index to the Solactive €STR +8.5 Daily Total return index as a result. Other ETFs in DWS's overnight rate swap range were also affected including the Xtrackers USD Overnight Rate Swap UCITS ETF (XFFE) and the Xtrackers GBP Overnight Rate Swap UCITS ETF (XSTR). According to the German asset manager, the rules are “materially the same” as the current indices.

3 November

DWS launches biodiversity ETF range

DWS became the latest asset manager to offer biodiversity-related exposure with the launch of three ETFs covering Europe, the US and global equities. *ETF Stream* revealed the Xtrackers World Biodiversity Focus SRI UCITS ETF (XBIO), the Xtrackers Europe Biodiversity Focus SRI UCITS ETF (XBEE) and the Xtrackers USA Biodiversity Focus SRI UCITS ETF (XBUZ) are listed on the Deutsche Boerse and the London Stock Exchange with total expense ratios (TERs) of 0.30%. The ETFs all track the relevant ISS Stocks Biodiversity Focus SRI indices which include a “multi-stage filter” to select stocks. Firstly, palm oil or pesticide producers will be excluded from the investment universe, while the remaining businesses with the “strongest negative impact” on biodiversity will also be excluded. Biodiversity and climate-related metrics will also be included.

8 November

big xyt unveils real-time consolidated tape for European ETFs

Data and analytics provider big xyt has developed a consolidated tape for European equities and ETFs that enables market

13 November

Fund selectors demand more granularity in fixed income ETFs

Investors grappling with a combination of recession fears and the risk of a second spike in inflation have been facing one of the biggest questions this year, how much duration should they have in their portfolios? Speaking at ETF Stream's ETF Buyer: London 2023, Sir John Royden, head of research at JM Finn said more granularity was needed in UK gilt ETFs in a bid to combat



this. He said the group had a desire “for more precise duration” and would love to see more granularity from ETF issuers. Francis Chua, fund manager at Legal & General Investment Management, echoed his thoughts adding that recent volatility has created more opportunities in the bond market. “We would like to see more granularity around regions and duration. With yields at 6%, ETF issuers should be able to launch a strategy that is attractive.”

participants to track pre- and post-trade volumes. It will allow businesses to monitor consolidated liquidity across the European ecosystem and includes unexpected off-book trading activity, trades of unusually large size, pending trades and sudden increases in over-the-counter (OTC) volumes. Developed alongside one of the world's leading asset managers, the tape will benefit trading firms, exchanges, dealing desks and issuers who will have the ability to access same-day, consolidated reports on market fragmentation, giving insight into the liquidity of any stock or exchange-traded product (ETP). The lack of a consolidated tape is thought to be one of the biggest challenges facing the European market with a regulated tape not set to be implemented until 2025.

8 November

Tabula adds unlisted share class to Paris-aligned ultrashort bond ETF



Tabula Investment Management became the latest issuer to offer unlisted share classes on

its ETFs. The fixed income specialist added the ability to create the share classes on the Tabula EUR Ultrashort IG Bond Paris-Aligned Climate UCITS ETF (TUCP) which launched in October. Tabula CEO Michael John-Lytle said the share class brings many of the benefits of an ETF to investors who are unable to trade the listed instrument. The group joined HSBC Asset Management in offering both listed and unlisted share classes of its ETF range and in August, PIMCO also announced plans to introduce the ability to implement non-ETF share classes within the same Irish-domiciled fund structure. Funds are required to have ‘UCITS ETF’ in the name if they offer an ETF share class alongside its mutual fund share class under European Securities and Markets Authority (ESMA) guidance.

9 November

FCA issues stern warning to high-cost and underdelivering wealth managers

The UK watchdog warned some wealth managers and stockbrokers offer “poor value” for investors through a combination of high fees, overly complex and inappropriate products and services. In its latest ‘Dear CEO’ letter published on 8 November, the Financial Conduct Authority (FCA) said many firms are not aligned with customers' needs such as offering expensive discretionary offerings for low-risk clients. It warned some wealth

managers do not disclose fees or charging structures consistently, meaning clients are not aware of the impact on their returns, while too many are not passing fair interest on client money balances despite rising interest rates. The FCA added it was unclear if clients are rewarded fairly when exposed to extra risk such as securities lending activities. “We will consider in future engagement whether you have taken appropriate action to rectify the root cause of any issues,” The FCA said. “We will take action if you have not.”

10 November

Vanguard closes German investment platform after less than two years



US giant Vanguard closed its direct-to-consumer (D2C) platform in Germany less than two years after failing to achieve the necessary scale to operate efficiently. The Vanguard Invest platform closed following a strategic review of its German business which has struggled to penetrate a market where several large investment platforms dominate. The \$7.8trn asset manager entered the market in 2017, offering investors access to its funds via financial intermediaries and investment platforms. Vanguard said it continues to manage \$30bn on behalf of German investors and remains committed to the region. Germany has been a key growth driver for Vanguard as its European ETF business hit \$100bn assets under management (AUM) for the first time earlier this year. In March, the group closed its UK financial advice arm less than two years after launching.

10 November

ARK Invest Europe shuts first Rize ETFs

ARK Invest Europe announced it would be shutting four Rize ETF products less than two months after the acquisition by Cathie Wood’s firm in September. Signalling its intent on the continent, the group said it would close

its emerging market and internet, education technology, pet care and medical cannabis ETFs. The latter is the largest with \$13.9m AUM. The group said it was decided to close the ETFs after its first anniversary if its assets remained below \$50m for 30 consecutive days. They are the first Rize ETF products to close following the purchase by Wood and leaves the European arm of ARK Invest with seven ETFs with roughly \$427m AUM when they cease trading on 12 December.

16 November

Cannabis ETFs snuffed out in Europe

The recent announcement of product closures from ARK Invest Europe and HANetf means that Europe will soon be without a cannabis ETF. In a further sign of consolidation in the thematic space, HANetf said the challenging backdrop for the cannabis industry meant the underlying index for its Medical Cannabis and Wellness UCITS ETF (CBDX) shrank as some pure-play companies became too illiquid to hold. It follows the closure of the Rize Medical Cannabis and Life Sciences UCITS ETF (FLWR) after Cathie Wood’s acquisition of Rize ETF in September. The closures are in part a symptom of the idiosyncratic risk faced by the sector. However, at the start of US President Joe Biden’s term in office, policy tailwinds helped drive more than 40% returns within a year.

20 November

EFAMA: UCITS ETFs could see \$1trn windfall from real-time consolidated tape

UCITS ETFs could be in for a \$1trn windfall from a real-time consolidated tape for equities and ETFs, the European Fund and Asset Management Association (EFAMA) has said. The recently-published report, UCITS ETFs: A growing market in volatile times, said around 10-20% of AUM held by non-US clients using US-domiciled ETFs – roughly \$1trn – could find their way into EU-listed products. EFAMA urged the European Commission to remain ambitious in delivering a consolidated tape for equities and ETFs adding that it would only serve to boost already increasing demand for the wrapper. It said pre-trade data with venue attribution is critical in providing a much-needed view of market liquidity, adding the EU has only taken “timid steps” so far, but remained positive a more robust framework could be implemented.

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For the latest news go to [ETF Stream](#)

Events

ETF Stream offers a series of in-person and online events throughout the year. These are predominately made up of webinars, roundtables and breakfast workshops, ETF Buyer series, ETF Buyers Club events, online events, and our flagship ETF Ecosystem Unwrapped and ETF Stream Awards.



ETF Buyer Series

ETF Stream's ETF Buyer event series takes place in venues across Europe throughout the year and offers professional investors insights into the trends that are set to shape markets over the next 6-12 months as well as deep analysis into the role of ETFs within portfolios. Our next in the series is ETF Buyer: London which is set to take place at the London Stock Exchange on 7 November. Find out more [here!](#)

Webinars

Our webinars present a unique opportunity for our sponsors to showcase their expertise as thought-leaders within the ETF universe and steer some of the industry's most important conversations. As part of this, *ETF Stream* has launched ETF Investigations, a webinar series that examines the key issues facing ETF investors in Europe. [Sign up here.](#)

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. Its bi-annual ETF workshop events encourage members to help shape the agenda, and include exclusive editorial analysis of every event sent directly to their inbox. To find out how to join, email tom.eckett@etfstream.com.



Roundtables

Each roundtable takes a deep dive into a relevant topic within the ETF space. From European regulatory developments to the ongoing demands for index providers, our roundtables provide a platform for experts to share their opinions on the ever-changing ETF landscape.

ETF Stream Awards

The ETF Stream Awards 2023 are now announced for its third year. The awards ceremony will bring together the European ETF ecosystem and aims to celebrate the industry's growth and achievements over the past 12 months. To see the methodology, and to access more information about table bookings, find out more [here.](#)



Revolving door

Movers and shakers, M&A, new launches

1 November

ETC Group poaches head of research from Deutsche Digital Assets

ETC Group, the crypto exchange-traded product specialist, named André Dragosch as head of research from Deutsche Digital Assets (DDA). Based in London and reporting to CEO Tim Bevan, he will lead the firm's research into digital assets. Having spent the last year as head of research for DDA based in Frankfurt, Dragosch was an investment strategist and cross-asset analyst for three years at Union Investment. Prior to this, he spent five years as a senior asset allocation analyst at FERI and two years at Helaba Invest.

6 November

Amundi poaches ETF head from BlackRock



BlackRock's Benoit Sorel was named global head of ETF, indexing and smart beta for Amundi following the departure of Arnaud Llinas.

Sorel, responsible for leading the French giant's passive arm, joined BlackRock in 2011 as head of sales for ETFs and index investing for France, Belgium, Luxembourg and Monaco before being promoted to lead BlackRock's product and distribution strategy for EMEA in 2018. Llinas departs Amundi after two years at the firm following its acquisition of French rival Lyxor. He spent 11 years at Lyxor, most recently as head of ETFs and indexing. Amundi has undertaken a major revamp of its ETF business following the acquisition.

14 November

RBC Brewin Dolphin promotes Mukhamedova

RBC Brewin Dolphin named Shakhista Mukhamedova as head of fund research. It comes after Michael Paul, formerly head of

equity fund research, left his role to take up a client-facing position at the wealth manager's Leeds office. Mukhamedova will lead the research team, working closely with Carlos Gonzalez Lucar, head of global manager research at RBC Wealth Management, British Isles, as the group looks to align its operations following the merger in September last year. She joined the business – formerly Brewin Dolphin – in 2010 as a fund analyst and has spent the last 18 months as head of fixed income and alternatives.

14 November

Close Brothers promotes Yan to passives head

Weixu Yan was promoted to head of passives at Close Brothers Asset Management (CBAM) following a leadership reshuffle at the company. Yan, who joined CBAM after it acquired Fortune Group in 2010, was previously head of ETF research while also working as a senior fund manager. Elsewhere, Giles Parkinson was promoted to head of equities reporting to CIO Robert Alster. He was previously managing director for global funds and held roles at Aviva and Artemis Investment Management. Alec Slater has taken on the role of head of alternatives while Matthew Stanesby became head of collectives.

15 November

Big Short's Michael Burry bets against BlackRock semiconductor ETF



Inspiration behind *The Big Short*, Michael Burry, held more than \$47m of bets against a BlackRock Semiconductor ETF at the end of Q3. Burry's Scion Asset Management bet against the \$9.6bn iShares Semiconductor ETF (SOXX) after concentration fears that manufacturers of the chips were driving much of the US equity gains so far in 2023. Nvidia, the third top holding in SOXX, has made gains of 246.9% year to 14

November and in May became the first chip maker to hit a \$1trn market cap. Advanced Micro Devices (9.2%) and Broadcom (8.2%) make up the rest of the ETF's top three holdings. Burry's recent filings also show Scion AM consolidated its portfolio, with its number of positions cut from 33 to 13.

16 November

Fineco AM expands thematic ETF range

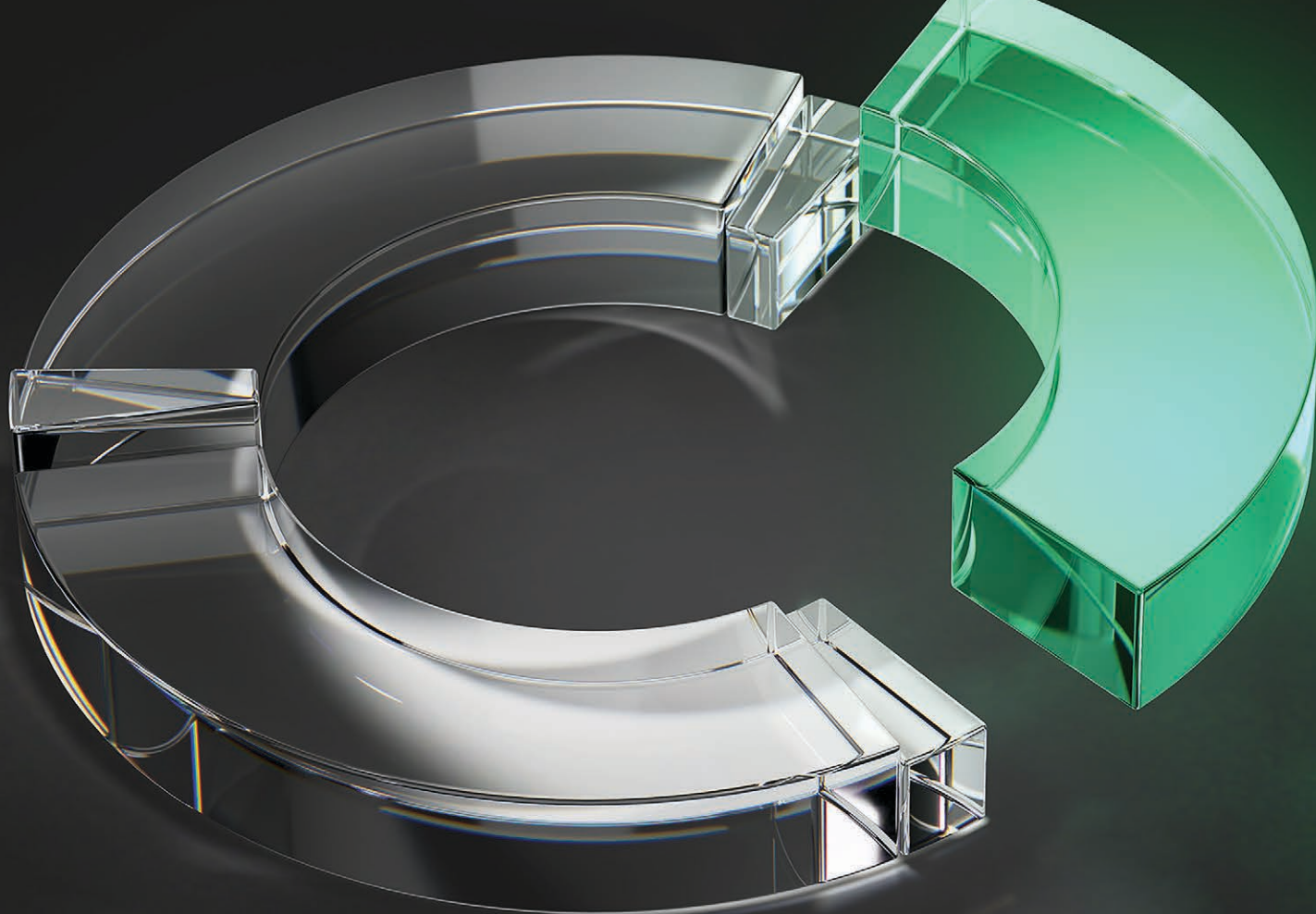
Fineco Asset Management launched six new ETFs including five thematic strategies just over a year after coming to market. *ETF Stream* revealed the Italian group's latest products comprise of the themes artificial intelligence, bioproduction technology, global clean energy, metaverse and Japanese equities. The ETFs all track MarketVector indices and are listed on the Euronext Milan with total expense ratios (TERs) of 0.38%. It takes Fineco AM's total range to 16 and said the decision to launch more thematic products was due to growing retail investor demand.

20 November

Global X CEO Berruga departs after a decade



Lui Berruga has stepped down from his role as CEO of Global X after almost a decade at the asset manager. Berruga made the decision "to spend more time with family and friends" after five-and-a-half years as CEO. He will be replaced by interim CEO Thomas Park, board member of Global X and co-CEO of the US arm of parent company Mirae Asset Global Investments. Berruga oversaw the group's entry into the European ETF market in December 2020 and also the doubling of its ETF market share and the acquisition of ETF Securities Australia in July 2022 during his time as CEO. He said he feels "extremely fortunate to have played a part in the development of such an impactful franchise".



The next chapter in sustainable ETFs

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ASSET MANAGEMENT



Thematic ETFs ‘become interesting’ with active management

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 Alex Funk of Schroder Investment Solutions

By **Jamie Gordon**

The intersection of active management with the ETF structure is “very interesting” and could spell a more selective route than the current screen-and-capture approach of thematic ETFs, according to Alex Funk, CIO of Schroder Investment Solutions.

Speaking to *ETF Stream*, Funk said innovation in the beta space is “broadly covered”, however, active management could

represent an attractive proposition in ‘index-plus’ broad market exposures and granular themes. New launches could “stress test ETFs a little more”, he said, by having a fund manager allocating across the entire value chain of a theme such as the energy transition.

“In that space, we have typically invested in active managers on a global basis. If there are more active-type solutions that come out within ETFs, that could become interesting. The thematic ETFs I have seen to-date focus on a theme and screen for those companies

“Index-plus’ or smarter optimisation active ETFs covering broad markets are on the radar and could challenge traditional active funds, as asset managers question whether the ETF structure is a more cost-effective and faster route to market”

and give you the access. What they do not bring you is the analyst approach, the qualitative, the soft components, at least not the ones I have seen.”

Predominantly passive

For now, the firm’s ETF usage is “purely passive”, with ETFs having “a prominent position” for capturing beta within their blended fund of funds range. “Certain markets will be more covered by analysts due to coverage and size of allocation so the inefficiency premia becomes less,” Funk said.

“We did an assessment across regions and asset classes and those with lower efficiency premia, we invested in passive ETFs to give us beta exposure. In other markets, such as emerging markets, small caps and alternatives, we would use active managers.”

However, he noted ‘index-plus’ or smarter optimisation active ETFs covering broad markets are on the radar and could challenge traditional active funds, as asset managers question whether the ETF structure is a more cost-effective and faster route to market.



Platform plague

Funk also highlighted the platform issue in the UK as a key structural barrier for many portfolio providers. “Although we love ETFs, they are limited creatures on platforms,” Funk said. “Today, we are on 14 platforms in the UK and three in the Channel Islands. Only five of those are able to facilitate ETFs which is difficult because we cannot have that inconsistency for client experience.”

Another challenge is the costs involved in accessing ETFs through platforms, which have brokerage costs, implementation fees and minimum deal sizes which do not exist when trading unit trusts. These costs risk “chewing away at the marginal performance” of clients, especially those with smaller account sizes. For this reason, the firm only uses ETFs within its fund structures, where trades happen at larger aggregate values and investors get the unit price and NAV, rather than numerous execution costs.

Jamie Gordon is senior features reporter at ETF Stream

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What is pre-hedging?

The practice has been labelled as frontrunning in some corners of the market

Pre-hedging is a murky liquidity provider practice that currently lacks uniform interpretation and regulatory oversight. The practice, which has been labelled frontrunning in some cases, is the process where liquidity providers hedge inventory risk in anticipation of a potential transaction. The anticipation of a trade is what separates it from regular hedging.

While this is the general definition understood by market participants, the definition of pre-hedging is yet to be enshrined in EU law which creates uncertainty for investors. In its 2022 Call for Evidence, the European Securities and Markets Authority (ESMA) defined pre-hedging as any trading activity undertaken by an investment firm where:

- The investment firm is dealing on its own account, and the trading activity is undertaken
- To mitigate an inventory risk which is foreseen due to a possible incoming transaction



- Before that foreseeable transaction has been executed
 - At least partially in the interest and benefit of the client or to facilitate the trade
- The practice can be used by liquidity providers as a tool for mitigating unwanted risks on their balance sheet if a trade has

“The practice, which has been labelled frontrunning in some cases, is the process where liquidity providers hedge inventory risk in anticipation of a potential transaction”

been pre-agreed with the investor. However, pre-hedging is particularly important for the European ETF market where over 50% of trades are executed via request-for-quote (RFQ) platforms.

When buy-side traders want to buy or sell a block of ETF shares via platforms such as Tradeweb and Bloomberg, they will send an RFQ to multiple liquidity providers that are competing to win the trade by showing the best price. Dealers will then select which price they want and the liquidity provider is responsible for executing the trade.

However, because dealers send the quote to multiple liquidity providers, any of them have the ability to ‘pre-hedge’ the position which causes information leakage and risks moving the market prior to the execution of the trade.

Therefore, RFQs could be seen to contain price sensitive information – not publicly available – that a liquidity provider has used to ‘pre-hedge’ a position, even without the knowledge of winning that specific trade.

This example of what has been described as pre-hedging evidently can lead to swings in price prior to the execution of a large ETF trade, a negative outcome for end investors.

As a result, it is important for buy-side traders to understand the pre-hedging behaviours of individual liquidity providers, show two-sided RFQs – a buy and a sell order – and to only show quotes to providers that have a history in filling orders in the asset class they are looking to execute.





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A Secure World



A Transitioning World



An Optimised World



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The sustainable investor for a changing world



Xtrackers FTSE Developed Europe Real Estate UCITS ETF (XDER)

This issue's ETF of the month is DWS's XDER, which booked a comeback on increased odds of an end to ECB hawkishness in the new year

This month's ETF in the spotlight from DWS staged a recovery over the past month amid hopes a reversal of monetary policy could spell an end to the eurozone's first house price declines since 2014. The \$750m Xtrackers FTSE Developed Europe Real Estate UCITS ETF (XDER) has gained 13.6% over the past month, as at 17 November, positioning it among the top-returning equity ETFs and the top-performing property sector ETF in November.

Despite recent gains, the ETF is still 35.4% down from all-time-highs in August 2021, owing to the European Central Bank hiking its policy rates – such as its deposit facility rate to 4% – since the start of last year.

Increased borrowing costs have been reflected in increased mortgage rates across EU member states, with house prices across the bloc falling by an average of 1.7% in the year to the end of H1, the first annual decline in almost a decade.

However, a recent turn of optimism has been sparked by eurozone core price inflation (CPI) falling from 4.3% in September to 2.9% in October. Meanwhile, eurozone GDP fell by 0.1% in Q3, with former ECB President Mario Draghi warning the bloc could be in recession by the end of the year.

While current ECB President Christine Lagarde stands firm in the view the policymaker will not start cutting rates in the near-term, it held rates steady at its November meeting and economists predict cuts could be implemented as early as H2 next year. In fact, Yannis Stournaras, governor of the Bank of Greece and member of the ECB Governing

Council, said interest rates could be cut if inflation remains below 3% by next August.

While higher rates have not historically spelled negative returns for ETFs and other vehicles capturing real estate investment trusts (REITs), these periods often coincide with periods of economic growth, allowing firms to benefit from higher rental prices.

However, higher rates also spell decreased property values, higher borrowing costs for REITs and XDER's dividend yield of 4.73% looks less attractive once policy rates have risen to almost match this level.

In a research note, S&P Dow Jones Indices (SPDJI) noted the negative impact of fast rate hikes on REITs. "This phenomenon was evident in May 2013, when Fed Chair Ben Bernanke suggested that the QE taper could start earlier than most market participants expected," SPDJI said. "Bernanke's comments led to a sharp sell-off of REITs and of some other asset classes, such as emerging market equities, which were viewed as reliant on 'easy money' from the Fed."

Given XDER tracks the FTSE EPRA Nareit Developed Europe index of 107 developed Europe listed real estate companies and REITs, its decline over the past two years a recovery over the trailing month make sense. A more sustained recovery will depend on if and when rates are cut, whether the EU can avoid a prolonged recession, if the labour market can remain tight and how these factors feed into property demand over the coming years.

STAT ATTACK

Ticker	XDER
AUM	\$750m
One-month return	13.6%
Constituent count	107
Data as at 17 November	

ETF BUYER ZURICH



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Fund Fights

State Street and Invesco S&P 500 ETF cost war

Fund Fights is a series where ETF Stream analyses the strengths and weaknesses of similar ETFs. This month, SSGA's SPY5 and Invesco's SPXS go head-to-head

Our final ETF head-to-head of the year sees a battle of the beta take place between Europe's long-standing lowest-cost S&P 500 ETF, the Invesco S&P 500 UCITS ETF (SPXS), and the newly crowned lowest-fee ETF in Europe, State Street Global Advisors' (SSGA) SPDR S&P 500 UCITS ETF (SPY5).

The older of the pair and Europe's largest synthetic ETF, SPXS has amassed an impressive \$20.4bn since launching in March 2010.

Launching in March 2012, SPY5 may have lagged to-date with its \$7.1bn asset gathering, however, this looks set to change with SPY5 seeing €1bn inflows since SSGA's decision to cut its total

expense ratio (TER) to 0.03% to become Europe's lowest-fee S&P 500 ETF. The move was facilitated by SPY5 being one of 67 ETFs added to SSGA's securities lending programme, allowing it to have up to 40% of its securities out on loan at any one time, with 75% of returns passed back to the ETF and 25% to the lending agent – State Street.

SSGA reported its US-listed SPY ETF returned 5.1 basis points (bps) by having 41% of its securities out on loan so far this year, as at 30 September. That same rate of return, with 40% on loan for SPY5, would imply 3.7bps could have been passed back to the ETF and 1.2bps back to State Street over the same period.

While this generous additional return would lower the cost of ownership even further, lending returns – and volume out on loan – will vary. In less fruitful periods, questions will be raised about whether SPY5 will be operating at a profit, with the 3bps TER and 25% of lending revenues having to offset the 3bps plus \$600k licencing cost for the S&P 500 index.

The key challenge for SPY5, however, is how it compares on a total cost of ownership basis against rivals including SPXS.

Some factors working in its favour include the lending revenues it will pass back to investors, its relatively tight 0.03% tracking error versus its underlying index, the fact it had an identical bid-ask spread on primary listing at the time of the fee cut – at 0.04% – and the fact its fee is a fraction of SPXS's, which boasts a 0.05% TER and 0.04% swap fee.

However, SPY5, as with all physically replicating S&P 500 ETFs, fall foul of SPXS's taxation trump card.

While being Irish domiciled affords SPY5 favourable taxation treatment under the double taxation treaty – paying 15% rather than 30% withholding tax on dividends – SPXS's synthetically replicating methodology means it benefits from the 2017 HIRE Act.

This enables Invesco to ensure SPXS's substitute basket is restricted to non-dividend paying stocks, meaning it pays no withholding tax on dividends paid by US companies.

Based on a current S&P 500 dividend yield of 1.62%, this affords SPXS currently enjoys an additional 0.24% of tax savings per annum. It may not be as low-fee or earnings lending revenues like SSGA's ETF, but SPXS is a reminder that costs are far more multi-faceted.

STAT ATTACK

Ticker	SPY5	SPXS
AUM	\$7.1bn	\$20.4bn
TER	0.03%	0.05%
Dividend withholding tax	15%	0%
Launch date	March 2012	March 2010

Data as at 20 November 2023

Features & Analysis

The Patient Investor

Why don't wars move markets?

Investors' subdued reaction to the Israel-Gaza conflict is consistent with a historic capacity to set wars in perspective

By Justin Reynolds

The sudden and shocking outbreak of war between Israel and Gaza would seem to have generated all the conditions for profound economic disruption.

The conflict is at the heart of Middle Eastern geopolitics, the region that is still the world's most important source of energy, producing a third of the planet's oil and host to nearly half of its proved reserves.

Past energy shocks have thrown the global economy off its axis. Average oil prices increased by 50% after the 1973 OPEC oil embargo and the Iranian revolution five years later, and doubled in the wake of Iraq's invasion of Kuwait in 1990. If the war continues it has the capacity to entangle powers beyond the immediate antagonists including the US, Iran and Russia.

And yet the market's reaction has been subdued. After stuttering on the outbreak of hostilities, global exchanges have quickly stabilised and even ticked up, not just the S&P 500 but those in Saudi Arabia, Egypt and the Gulf states closest to the conflict. Even the oil market has seen relatively little drama, prices spiking briefly before falling back.

It is true that the world's oil infrastructure has become more robust, less vulnerable to shocks. Supply is more diverse, strategic reserves are larger and global output is less intense. But the reasons for investors' muted reaction run deeper, the latest instance of a historic tendency to respond to war with restraint.

Analysis of the market's responses to 25 geopolitical crises since World War II shows that the

S&P 500 dropped on average by around 4% after 15 days, recovering fully after 33. The Dow Jones rose by 50% and 60% through World War II and the Korean War, respectively, by 43% from 1965-73 during the Vietnam War and the S&P 500 recovered an initial 12% loss within a month of 9/11. US exchanges grew even through the Civil War, recording a net loss only during World War I. The pattern is the same, exchanges recovering swiftly after an initial sell-off. And if anything the reaction to the Gaza conflict has been more restrained than usual.

The wisdom of crowds?

The market's characteristic stoicism in response to war would seem to be a prime example of the wisdom of crowds, evidencing a collective capacity to recognise geopolitical risk as a historical constant, and retain faith in the capacity of the global economy to adapt.

To be sure, investors' propensity for sagacity should not be sentimentalised. Markets are vulnerable to short-term panic. Global stocks fell by a third in the six weeks after the outbreak of the pandemic, and flatlined for months after Russia invaded Ukraine. But they soon sparked back into life. Each new crisis generates as many voices counselling caution as those forecasting doom. Human nature is disposed to view each new emergency in apocalyptic terms, but those who have seen much wonder if the Middle East is really more precarious than it has ever been, whether Russia's nuclear grandstanding is really worse than during the Cuban missile crisis or whether China, weakened by an economic slowdown, is really prepared for war with its neighbours.

“The market's characteristic stoicism in response to war would seem to be a prime example of the wisdom of crowds, evidencing a collective capacity to recognise geopolitical risk as a historical constant, and retain faith in the capacity of the global economy to adapt”

History teaches that the global economy has a remarkable ability to adapt to conflict and crises. And that it is perennial bread and butter economic issues that really move indices. This year, markets have been more finely attuned to speculation regarding interest rate policy than imponderables that may ignite further conflagration in the Middle East.

Shares have risen in past weeks in response to central bankers' hints of lower interest rates and the possibility of support for the Chinese economy, overriding concerns about an escalation of the conflict. For sure, oil prices rose immediately after 7 October, but those gains have since been wiped out by overriding concerns that recession will weaken demand for energy. The market's stagnation in the aftermath of Ukraine had more to do with anxiety about higher interest rates than fear that Putin might press the button. And equi-



ties soared after the pandemic once investors were assured that governments would underwrite economies through liberal monetary and fiscal policy.

The difficulties of doing nothing

What, then, are the implications for investors? Perhaps when war breaks out, they are best advised to nothing. Certainly – human suffering notwithstanding – conflict can open near-term investment opportunities in the trade of sensitive assets such as commodities and defence stocks. But history indicates there is no guarantee those securities will move as might be expected.

Writing for *ETF Insider* last November in the context of the Ukraine war, Nicolas Rabener evaluated the performance of US stocks during the Civil War and the two world wars, and found that industries that were deeply involved in the war effort such as heavy machinery and defence companies were outflanked by unsung sectors such as printing and publishing, beverages and personal services.

Defence stocks, and, as noted, commodities, have recorded modest gains during the present

conflict. Gold, a traditional haven in times of war, has performed rather more strongly, surging as much as 10% to nearly \$2,000 an ounce. But the mercurial yellow metal defies expectations as often as fulfilling them. It is linked with US dollar weakness, yet during the 2000s its value held as the US dollar rose. It is billed as an inflationary hedge but failed to spark through a period of intense economic uncertainty. And it did not move much during the Gulf War or the invasions of Afghanistan or Iraq.

Diversification, again

Therefore, investors might be well advised to follow the most humdrum financial advice: hold a well-diversified portfolio able to absorb the losses that war inflicts, and with exposure to whatever assets do rise. Above all, they should retain faith in equities, the primary fuel driving long term returns. The time-worn evidence is that over the past century US and UK equities have returned an average of 6.7% and 5.4% year-on-year after inflation. Unspectacular, perhaps, but sufficient to allow for powerful compounding.

We live in a world of war and ‘radical uncertainty’, as John Kay and Mervyn King put it, but over time to put one’s faith in the markets is simply to trust that the spirit of human enterprise will prove resilient, generating wealth in which every investor can share.

For Vanguard founder John Bogle “the stock market is a giant distraction that causes investors to focus on transitory and volatile investment expectations rather than on what is really important – the gradual accumulation of the returns earned by corporate business”. And low cost index funds offer the best means of securing a fair share of those returns.

Quite apart from its other consequences conflict presents investment risk. But in the long run there are, perhaps, greater risks. The age-old economic issues of inflation and interest rates, and for investors, our natural tendency to be distracted from the often bruising business of waiting for gains to accumulate, through times of war as well as peace.

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





ESG flavour has ‘massive impact’ on performance dispersion

Are gaps between ESG approaches as concerning as the opacity involved in constructing some of them?

By **Jamie Gordon**

Some investors may let their moral convictions steer which of the many ESG buckets they prefer; however, this could change if choosing an ESG tilt continues to be as impactful on ETF returns as picking an underlying exposure.

The myriad flavours of ESG fairly reflects the range of views on what the acronym should encompass, with any one benchmark potentially available in ESG mainline, select, leaders, elite, Paris-Aligned, climate transition, net zero, socially responsible and other iterations.

But, as many of the more esoteric flavours of ESG are field tested outside of index provider

“Even for strategies that look mostly the same on paper, performance can vary meaningfully. There is a 10% performance spread in 2023 between a selection of ETFs tracking slightly different versions of the MSCI World Paris-Aligned Index, for example”

lab settings – and set against the more modest tilting strategies – wide performance dispersion and tracking error will surely be sending fund selectors’ fiduciary alarm bells ringing.

Speaking at *ETF Stream*’s ESG ETFs Workshop 2023, Jack Turner, head of ESG portfolio management at 7IM, said: “Investors need to understand the underlying index methodology and see how that has worked over time.

“I was recently analysing some US ESG ETFs and year-to-date, there has been a 5% spread, on the conservative side. Given the S&P 500 is currently up around 9% so far this year [to the end of October], clearly ESG methodology can have a massive impact and that is dependent on your level of tilt.”

In fact, with the S&P 500 jumping 10.7% in less than a month to 22 November, the year-to-date dispersion among ESG ETFs tracking the index widened to 7.8%, excluding sector, factor and equal weight strategies, according to Bloomberg Intelligence data.

Interestingly, the performance dispersion from 15.2% to 23% straddles the 19.2% return for parent index over the same period, showing not all ESG ETFs have been buoyed equally by the style rotation and boom in big tech names in 2023.



Also notable is the fact this year's dispersion is wider than the 7.2% return spread over the trailing three years for the same cohort of ETFs.

This suggests the ebb and flow of different investment styles impacts different flavours of ESG over time, as evidenced by leadership in the group changing from an ESG leaders strategy to a Paris-Aligned climate ETF on three-year and year-to-date timeframes, respectively.

The fact a disparity in returns was maintained over both periods also suggests dispersion is a regular rather than freak occurrence.

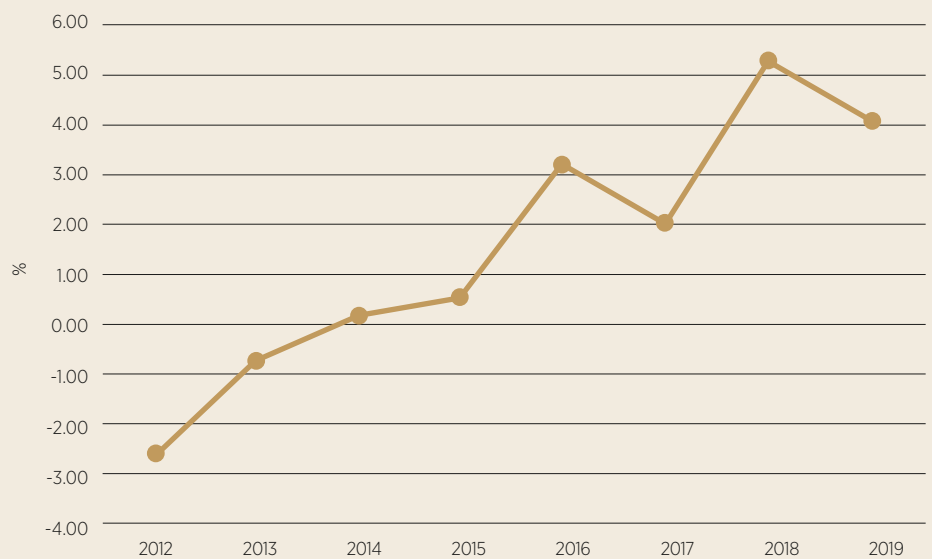
Unsurprisingly, performance gaps were also notable in the larger suite of more than 20 ETFs tracking ESG iterations of the MSCI World.

This year, the return spread is 7.32% and a considerable 13% over the trailing three years, as at 22 November. Once again, both spreads straddled the performance of the parent index over the different periods.

Fund selectors react

Commenting on the rift within ESG approaches, Turner said: "This is not an issue. In fact, it is good there are some ETFs that are very 'light touch' in their ESG approach, which we can start

CHART 1: DIFFERENCE IN ESG RATINGS BETWEEN MSCI AND REFINITIV (%)



Source: Agarwal et al, 2023.

to introduce into our portfolios, which we do. "We do not want too much factor risk, but we do want to start to tilt away from the biggest polluters, so there are some ESG ETFs out there that provide us with those kind of low tracking error options. There are also the ones which we have in our ESG mandates which take a lot of active risk."

He argued investors need only be aware of a benchmark's underlying rules and any changes in these, which impact what they are being exposed to.

James Peel, portfolio manager at Titan Asset Management, said: "Even for strategies that look mostly the same on paper, performance can vary meaningfully. There is a 10% performance spread in 2023 between a selection of ETFs tracking slightly different versions of the MSCI World Paris-Aligned Index, for example."

However, he said the broad array of products means enables wealth managers to construct a basket of sustainably labelled equity strategies that optimise for low tracking error despite applying significant exclusions.

"If, for example, across our core proposition we are tactically overweight the value style factor, or underweight European stocks, we are now able to reflect these views across our sustainable investment proposition in a way that was not possible a few years ago – before the growth of our sustainability-labelled investable universe."

ESG ratings more troublesome

Setting flavours of ESG aside, perhaps more problematic are the inputs measuring which securities deserve to be represented within ESG indices and how these inputs are determined.

For instance, a paper titled ESG Ratings of ESG Index Providers, found MSCI – which derives

60% of its revenues from its indexing business – awards higher ESG ratings to top-performing stocks than their ESG 'fundamentals' can justify, so they can be overweighted in their ESG benchmarks, which then book flattering performance.

The research found ESG ratings from MSCI are systematically higher than those from Refinitiv, whose ratings are not relied upon by "any significant index", and stocks' ESG upgrades and downgrades relative to peers were inexplicable using performance on ESG metrics.

"Collectively, our findings suggest that ESG data providers' index licencing incentives influence their ESG ratings," the report said.

Joachim Klement, investment strategist at Liberum Capital, warned such dynamics indicate there may be "monetary conflicts of interest at play in some cases", with inclusion in MSCI ESG indices linked to past performance.

While MSCI responded, stating its index design and calculation is "functionally separate" from the assignment of ESG ratings, opacity in the transmutation of ESG metric data – from ratings to index construction – is already the subject of regulatory concern, with the European Commission proposing rules for ESG ratings providers in June. Overall, large performance disparities between flavours of ESG approach are material but less concerning for investors able to look beneath the bonnet of each index and understand what they are buying.

However, the way each of these strategies is constructed – especially those more reliant on ratings than tangible metrics such as emissions data – needs to be audited to uncover whether many ESG strategies are worth having at all.

Jamie Gordon, senior features reporter at ETF Stream



AXA IM’s Wadia: ‘It is not sustainability at all costs, financial returns are imperative’

Investors are increasingly approaching their ESG goals with a dual objective: financial returns and sustainability purposes. AXA IM is helping with both

By Theo Andrew

Jane Wadia, head of investment specialists at AXA Investment Managers, said ESG is now part of “every conversation” the French asset manager has with clients, however, sustainability needs are alongside financial returns, not in lieu of.

Sustainable investing returns have been under pressure over the past 18 months as geopolitical events have dragged on performance, but contrary to prior market cycles where ESG has come to the fore and then been shunned, this time it remains key.

Increasingly, institutional clients are making commitments to decarbonise their portfolios and distributors are building sustainable offers for

their discretionary and advisory clients. Wadia said AXA IM has been catering to clients’ needs in this area with the launch of its Euro and US Credit PAB exposures, noting the role that active ETFs can play in boosting returns. She added several emerging themes are seeing increasingly popularity, such as biodiversity and the growing role of fixed income ESG in portfolios.

What are clients trying to achieve with their ESG investments?

In Europe, we are seeing investors evolve their investment approach to allocate capital that not only delivers a financial return but that also supports the transition to a lower carbon economy. ‘Net zero’ investing is one good example of this

with clients making commitments to decarbonise their investment portfolio. Others are looking for building blocks to create a sustainable range for their end clients. And where we fit in is by designing concrete investment solutions to help them achieve this, such as developing PAB ETFs.

Which themes are clients most interested in?

Of the three letters in ESG, the ‘E’ - the environmental pillar - is of most interest to our clients, particularly around the themes of biodiversity and decarbonisation. Clients are interested in decarbonising their investment portfolio and we work closely with them across credit and equities to achieve this.

Euro credit, which is a significant allocation or building block in the portfolios of our continental European clients, is a great example. We recently launched a Euro Credit PAB UCITS ETF in July and our US Credit PAB UCITS ETF in November, precisely for clients looking to decarbonise their portfolios while achieving a return on their investment.

The other area we see an investment case for is biodiversity. One of our convictions at AXA IM is that we cannot address climate change without simultaneously addressing biodiversity loss. For example, agriculture is responsible for 80% of deforestation as well as circa 24% of global greenhouse gas emissions. Similarly, higher temperatures and more extreme, less predictable weather conditions are projected to affect the availability and distribution of rainfall and further deteriorate land quality and crop yields. While biodiversity is still a relatively new theme within listed equities, conversations with clients have increased substantially over the past 12-18 months.

How do you capture these themes at AXA IM?

We have developed biodiversity and climate listed equity investment solutions, including ETFs, which are managed in line with our convictions:

- A significant and rapid impact on biodiversity can be achieved by listed companies which can provide scalability and are supported by capital markets
- Sustainable Development Goals (SDGs) data available now offers the ability to define a credible biodiversity investment universe
- Listed companies can tackle biodiversity loss either through innovative products and services (P&S) and/or reducing biodiversity footprint through operational activities
- We have identified four SDGs that address biodiversity loss (see figure 1).

FIGURE 1: FOUR SDGs THAT ADDRESS BIODIVERSITY LOSS



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In terms of net zero investing and supporting the transition to a lower carbon economy, AXA IM is one of the founding members of the Net Zero Asset Managers (NZAM) initiative which commits us to net zero by 2050.

As part of that, we have pledged to reduce the carbon intensity of our corporate assets by 25% by 2025. To help us implement this, we have built our own framework which is a combination of qualitative research and quantitative data to map companies across the carbon transition spectrum – from climate leaders to climate laggards.

What advantages do active ETFs have when investing in ESG?

We are constantly trying to combine areas where there is an investment case, where we have conviction, and where we can meet client demand. Being active allows our portfolio managers a little bit more flexibility to provide potentially better financial returns. One key advantage we have is that we have been doing active management for decades.

Our actively managed ETF ESG offering can add value by allowing our portfolio managers

more flexibility to find investment opportunities or equally to minimise the investment risks. It is not a binary active or passive discussion though. It is whether the exposure we are looking for can be met through an actively managed approach, something completely passive, or something in the middle that has a tilt to active but limits the tracking error, and combining that with the demand we see from clients.

How will ESG fit into clients' asset allocation going forward?

We will continue to see the 'E' dominate for the foreseeable future. We see clients looking to al-

locate across their portfolios through regional building blocks as well as through global strategies in both equities and fixed income.

Sometimes it is used as an allocation building block, in which case, they may want something more regionally focused. In other cases, they are looking for more transitional exposure to the market.

The ETF landscape is growing fast and has mainly been an equity story so far but we are seeing increased demand for fixed income ETFs and particularly innovative ESG solutions in the fixed income space, that can combine the aspects of sustainability and financial performance clients are seeking.

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Desiree Fixler: ‘SFDR has been a waste of taxpayers’ money’

ESG alphabet soup ‘only benefits politicians and consultants’

By Theo Andrew

Former DWS group sustainability officer Desiree Fixler has slammed the Sustainable Finance Disclosure Regulation (SFDR) labelling it a “waste of taxpayer’s money”.

Speaking at ETF Stream’s ETF Buyer London event, the DWS greenwashing whistleblower said the regulation may have been “well intentioned” but has “overly burdened asset managers and only benefits politicians, taskforces and consultants”.

“SFDR was very well intentioned but has been an absolute waste of taxpayers money,” Fixler said. “Whether it is SFDR or CSRD, do we really need a classification system? Why cannot companies just say what they mean when they are investing sustainability?”

“SFDR was very well intentioned but has been an absolute waste of taxpayers money. Whether it is SFDR or CSRD, do we really need a classification system? Why cannot companies just say what they mean when they are investing sustainability?”

She added the European regulator has been overly prescriptive in overseeing ESG investing versus its US and UK counterparts via its Article 8 and Article 9 classification regime.

“Brussels and the financial regulator came out and felt like they could overregulate and burden companies with so much reporting that they have no choice but to invest in green activities,” Fixler said.

“It is a very prescriptive model where Brussels wants to shame asset managers do not offer Article 8 or Article 9 funds, or if a company is not moving into renewables.”

Fixler’s comments come as the European Commission launched a full-scale review of SFDR in September to address its shortcomings and allegations that it has led to increased greenwashing.

The consultation, which is due to run until mid-December, is likely to turn the disclosure regime into a labelling regime in a bid to make it easier for investors to understand and more closely align it with the Financial Conduct Authority’s (FCA) Sustainable Disclosure Regime (SDR).

However, Fixler – who shot to prominence after calling out the greenwashing practices of her former employer DWS – praised the FCA’s “practical” approach to product classification.

“The FCA, like the Securities and Exchange Commission (SEC), has the overriding element of whatever you are doing, do not mislead, do not miss out and do not miss represent,” she said.

Fixler added SDR sits in the middle of the SEC and EU’s attempts to oversee sustainable investing.

“The SEC is not telling investors how to invest. Just make sure you are telling the truth and do what you say you are doing, and if not, we are watching, we will crack down and arrest people,” she said.

In August, Fixler said it was time to “retire the term ESG” after a Bloomberg survey revealed firms are under pressure to stop using the acronym in conversations with clients following a highly charged political debate in the US.

A recent Greenpeace report called out Fixler’s employer DWS for a “new form of greenwashing” claiming its revised sustainability bonus scheme only served to capture “irrelevant corporate metrics” as opposed to concrete climate objectives.

The bonus scheme was restructured to remove conflicts of interest which caused former CEO Asoka Woehrmann to step down in 2022.

Theo Andrew is news editor at ETF Stream

SFDR overhaul poses challenges for ETF investors

The fund industry and national regulators are lobbying for an overhaul of the existing SFDR disclosure framework, scrapping Articles 8 and 9, but this could pose significant issues for UK fund selectors

By Theo Andrew

A complete overhaul of the Sustainable Finance Disclosure Regime (SFDR) labelling framework could pose challenges for UK investors looking to integrate UCITS ETFs into their portfolios, fund selectors have warned.

ETFs domiciled in the EU could face “difficulties” in a UK regime unless the new SFDR framework adopts the same labels as the Financial Conduct Authority’s (FCA) Sustainable Disclosure Regime (SDR).

The FCA recently announced it will introduce the Overseas Fund Regime (OFR) in April 2024, removing a key post-Brexit barrier for new EU-domiciled ETFs when entering the UK.

However, Damien Lardoux, head of impact investing at EQ Investors, said some European-domiciled ETFs could be ruled out of his portfolios unless the FCA and the EU adopt the same sustainable definitions for labelling funds.

“The FCA believes a labelling approach is better and it is interesting to see potentially Europe following suit,” he said. “One of our challenges is to get the UK and Europe to adopt the same definitions as otherwise it creates challenges to build portfolios.

“If labels are different in the UK and Europe, to get a label in the UK, that might rule out a number of European funds to be added in our portfolios.”

It comes as the European Commission launched a consultation into SFDR in September which could lead to the potential overhaul of the current Article 8 and Article 9 classifications in favour of fresh labels. The four new category proposals out-

lined by the European Commission – one more than SDR – are designed to closely align with the FCA’s sustainability disclosures; sustainability focus, improvers and impact. A fourth category is for funds that exclude activities with negative environmental or social effects.

Ongoing dialogue

Gavin Haran, head of policy for asset management at Macfarlanes, said he believes non-equivalence between EU and UK labelling regimes could pose difficulties for ETFs with the OFR set to be introduced next year.

“Some of the funds being authorised in the EU would have some difficulty if you were to put them in the UK regime, particularly with offshoring coming in,” he continued. “The FCA has said it does not want to cause issuers massive problems with divergence so it sounds like there will be an ongoing dialogue between the UK and the EU.

“Hopefully it would not shoot the ETF industry, given the expansion of ETFs and particularly at this stage of growth for the market.”

Despite this, it is believed the European Commission is favouring keeping the existing framework, developing more clarity over ‘non-ESG’ Article 6, ‘light green’ Article 8 and ‘dark green’ Article 9 which would “not map very neatly” with SDR. “For practical reasons [keeping the current framework] will be more likely,” Haran said. “If you keep Articles 8 and 9, the industry already uses the terms ‘light green’ and ‘dark green’ anyway. You might see a numbering system come in, so six, eight and nine, but you could potential-

“If you keep Articles 8 and 9, the industry already uses the terms ‘light green’ and ‘dark green’ anyway. You might see a numbering system come in, so six, eight and nine, but you could potentially see another category added, 8.5 for example”



ly see another category added, 8.5 for example. But a ranking system would be different to labels proposed by the FCA.”

Sergey Dolomanov, partner at William Fry, said going down such a route risks having the same greenwashing problems unless the defined quality measures – such as minimum sustainable investments – are improved. “If we leave too much room for interpretation you again risk some form of greenwashing,” he said.

Lobbying

The European Commission’s position puts it at odds with much of the industry and many na-



tional regulators who have been lobbying for a new labelling regime.

The Dutch regulator AFM recently called for a complete overhaul of SFDR which includes the removal of Article 8 and Article 9 in favour of new product labels. The Institute for Energy Economics and Financial Analysis (IEEFA) also said the current system should be overhauled in favour of a new labelling regime.

Haran added: “We are now in the period of quite heavy lobbying, mainly from regulators and national governments worried about greenwashing. France has brought in a lot of rules locally to try and deal with the issue.”

While asset managers have been tight-lipped

on the potential developments, BNP Paribas Asset Management (BNPP AM) backed a revamping of the current framework – keeping Article 8 and Article 9 – given the efforts the industry has made in implementing the structure to date, *Responsible Investor* reported. However, Dolomanov said asset managers in general will not be too concerned about wholesale changes to the framework given they will have to update the new proposals in whichever form they take.

“If SFDR is reformed, and it looks set to be reformed, asset managers will have to adapt to the changes in the documents,” Dolomanov said. “The positive thing is the Commission is open to criticism, this is shown in the consulta-

tion question around cost proportionality of the implementation of SFDR ‘level 1’ and ‘level 2’.

“Simplification for the end investor is the desirable outcome,” Dolomanov added. “The demand from asset managers for a labelling regime was clear by the way current Articles 8 and 9 were being used.”

Whichever route the European Commission decides to take it is not likely anything will be legislated for until 2026 at the earliest, meaning issuers and investors will be using Articles 8 and 9 as a defacto labelling regime for some time to come.

Theo Andrew is news editor at ETF Stream



Tracking the low-carbon transition

How investors can align their portfolio to the structural shift towards an eco-friendly economy with thematic ETFs

Thematic investing is about looking towards the long-term and orienting portfolios towards the big structural changes that will define our era. With that in mind, our BlackRock Investment Institute has named the transition to a low-carbon economy as one of five mega forces that we see as structural shifts bringing significant

changes in profitability across economies and sectors. The transition to a low-carbon economy is driving an economic transformation spurred by government policy, technological innovation, and consumer preferences.¹

In 2022 alone, \$1.1trn of global capital was committed to low-carbon energy supply invest-

ment solutions, crucial to bringing us closer to the transition to a low-carbon economy.²

Investors looking to align their portfolio to the transition to a low-carbon economy can choose from a range of iShares thematic ETFs, that are designed to benefit from or contribute to the transition. Let us take a closer look at the themes shaping this range.

Clean energy - towards a renewables-powered economy

A key focus of the transition to a low-carbon economy is on the highest-emission segment: power generation.³ Industrial advances are driving energy independence and reduced-emissions targets, which combine to boost investment in



clean-energy infrastructure and technology. In 2022, 86% of all newly contracted renewable capacity had lower costs than fossil-fuel-fired electricity, indicating how production costs associated with renewable energy now rival those of traditional power sources.⁴

Essential metals - needed for a low-carbon transition

Minerals such as copper, lithium, nickel and rare earth have unique characteristics that are useful for constructing the technology required to transition to a low-carbon economy, including renewable energy systems, wind turbines, solar panels and electric vehicles. The acceleration of the low-carbon transition, coupled with

supply-chain challenges, could present growth opportunities for miners and producers of these essential metals.

LITHIUM - CHARGING AHEAD Lithium is an important metal for electric vehicles and energy storage. Companies involved in the production of lithium and lithium-battery producers could benefit from increasing demand for these technologies, with annual lithium demand expected to increase 22x between 2022 and 2050 in the Net Zero Scenario by BloombergNEF.⁵

COPPER - WIRING THE PRESENT TO THE FUTURE Copper plays a role in all things linked to electrification, so copper miners are one of the main groups likely to benefit from the low-carbon

transition. For instance, in power production, copper is used intensively in manufacturing wind turbines and solar cells. And in transportation, electric vehicles use 2.5x more copper than non-electric cars.² By 2035, it is estimated that copper demand will nearly double from 2021 levels, with most of this growth coming from transition-related demands.⁶

Index funds, including ETFs, can provide exposure to strategies with a focus on preparing for, being aligned to, benefiting from and/or contributing to the transition to a low-carbon economy.

To learn more about transition thematic ETFs, visit www.ishares.com/uk/individual/en

¹ BlackRock Investment Institute (BII), 2023 Global Outlook: New Regime, New opportunities, as at 31/07/2023

² Bloomberg NEF Global Low-Carbon Energy Technology Investment Surges Past \$1 Trillion for the First Time, as at 26 January 2023

³ IEA CO2 emissions in 2022, as at 30/03/2023

⁴ IRENA, Renewable Power Generation Costs in 2022, as at 30/08/2023

⁵ Bloomberg NEF Electric Vehicle Outlook 2023

⁶ S&P Global, 'The Future of Copper - Will the looming supply gap short-circuit the energy transition?', as at 31/07/2022

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Transition metal ETFs: Must-have or unnecessary risk for ESG investors?

Accessing the materials underlying the shift to clean energy, with political risk, ESG concerns and portfolio construction red flags under the bonnet

By **Jamie Gordon**

A spate of launches has earmarked transition metals as a hot topic within ETFs, yet it falls to fund selectors to assess the value added by commodities as thematic exposures, their role in portfolios and even their ESG credentials before adding metals to their sustainable allocations. BlackRock – which this year launched copper mining, ‘essential’ mate-

rials and lithium and battery ETFs – warned the metals are needed for the “monumental” shift to green energy have been greatly underestimated.

In fact, the world’s largest asset manager said the growth of renewable energy, electric vehicles and battery storage will double collective demand for copper, rare earth elements, aluminium, lithium and cobalt by 2040. “The demand for metals and materials is poised to surpass all prior estimates,” BlackRock said in a report in October.

Evy Hambro, global head of thematic and sector investing at BlackRock – and co-manager of the BlackRock World Mining Trust – added the energy transition risks being hindered without additional funding being funnelled into metal and mineral extraction.

“If people do not give this sector a chance, then the energy transition is going to be impeded by the scarcity of materials to build everything required,” he said. “This energy transition is starting to expose some weaknesses in that kind of complacent attitude.”

Hambro noted while clean energy stocks have typically carried lofty valuations, “the further you get away upstream from the renewable power companies, the lower the multiples go”.

This valuation mismatch and momentum gathering in the transition commodities narrative have prompted mining equity ETF and exchange-traded commodity (ETC) launches from the likes of WisdomTree, Global X and Legal & General Investment Management



(LGIM) in recent years, with BlackRock, UBS Asset Management and Sprott Asset Management entering the space in 2023.

Any takers?

Responding to BlackRock's trio of launches, Aaron Bright, assistant portfolio manager at IG, previously said the products offer "some excellent qualities and niche exposures" which will be "very relevant to investors keen to access the decarbonisation megatrend".

The copper miners ETF, in particular, he said could "be like buying spades in a gold rush" with copper demand expected to double by 2050; however, his firm would not be allocating due to the ETF's thematic nature.

Alex Funk, CIO of Schroder Investment Solutions, identified decarbonisation as one of his firm's three 'Ds' to drive the macro agenda over the coming decade, with a lack of metal supply a key concern. "There is a structural investment in commodities that is required over the next dec-

"The trouble with a narrow theme like copper miners is that there are not enough profitable copper miners to create an index so you end up with a lot of other stuff. For instance, the biggest component in the ETF is BHP whose core business is iron ore"

ade, but also to sustain the transition for some fossil fuel companies," he said. "Therefore, we like commodities within that space.

"The energy transition is a theme we play in two ways. One of which is to have exposure to the commodities that will have a structural tailwind off the back of that."

New risks emerge

However, drilling down into what makes these products tick – at least on the ETF side – suggests investors may be taking on unintended risks.

For instance, these ETFs as with other thematic capture a narrow group of stocks – sometimes as few as 30 names – with some fund selectors believing this exposes them to unrewarded volatility.

Peter Sleep, senior investment manager at 7IM, said: "This holds true for these transition ETFs, but at least the big mining companies have things like a viable business model, profits and cashflows that were missing from some of the companies in thematic ETFs that came out in 2020/2021.

"I wish I could say this about all the mining companies in these ETFs. When you look in the weeds, you may find companies that look a lot more speculative."

Sleep added transition metal ETFs also introduce new risks not as prevalent in the existing thematic roster. "Many older thematic ETFs bought companies operating in developed markets. Many mining companies carry a lot of country risk," he said.

An example of this is First Quantum, a Panama-focused copper miner held by several transition and battery ETFs, which saw its share price halve in October, with the mine it spent years and billions of dollars to bring online now on the brink of closure following ongoing blockades of a key port. The compromise for reducing these idiosyncratic risks is holding more generalist mining operators, which some including the iShares Copper Mining UCITS ETF (COPM) do.

"The trouble with a narrow theme like copper miners is that there are not enough profitable copper miners to create an index so you end up with a lot of other stuff," Sleep continued. "For instance, the biggest component in the ETF, with a 10% weighting, is BHP whose core business is iron ore."

Other components of the ETF include Vale, Glencore and Newmont, whose core businesses are in iron ore production, coal and gold, respectively.

The obligatory ESG

Lastly, the crossroads between mining companies and ESG may be a tired discussion, but it remains an important one to square, especially for professionals explaining their allocations to sustainability-conscious retail clients.

Robert Eccles, professor at the Said Business School, Oxford University, argued the energy transition is littered with trade-offs and current mining operations are just one such example.

"Electric vehicles require cobalt and most of it comes from the Democratic Republic of Congo, which uses child labour to mine it," he said.

However, even pragmatic ESG investors will draw their own moral lines between operational realities and unacceptable controversies. An example might be the activities of copper mining company Ivanhoe – currently a top holding in several copper miner ETFs – and its colourful chairman Robert Friedland, also known as 'Toxic Bob'.

The Canadian Centre for Policy Alternatives said in 2001 Ivanhoe ran a joint venture with the "Burmese military dictatorship", reliant on "forced labour".

The report said: "Here is a Canadian mining investor linked to major environmental disasters and mercenaries joining with a military junta that killed 10,000 people in 1988 – to crush a student uprising – and has turned Burma into a vast slave labour camp, as well as the world's leading heroin exporter."

While a specific incident, this is just one of many examples of unsavoury collaborations between resource extraction companies and problematic political entities.

For instance, until forced to close by Russia's invasion of Ukraine last year, Norilsk Nickel – founded out of what was previously the NKVD-run Norillag gulag and also the perpetrator of a 17,500-tonne diesel spill in Siberia in 2020 – had its own ETC issuing arm offering copper, cobalt and even electric vehicle metals ETCs.

Despite some worthy health warnings, the transition metal ETF and ETC roster continues to fill out in Europe. Time will tell whether these strategies can allure investors looking to capture the clean energy value chain, though eventual economic recoveries and pivots by central banks may be supportive to valuations in coming years.

Jamie Gordon is senior features reporter at ETF Steam

The tyranny of choice: Is the ESG ETF landscape overwhelming fund selectors?

Fund selectors are having to wade through an ever-expanding ESG ETF landscape as it continues to evolve. Investors welcome choice, but there are signs they could be growing weary of the growing complexity in the market

By Theo Andrew

The unstoppable rise of ESG ETFs has continued almost unabated in Europe despite a challenging 18 months for the market hit by several headwinds.

Flows have remained resilient – continuing to grow beyond their market share – while launches of ETFs labelled Article 8 and 9 under the Sustainable Finance Disclosure Regulation (SFDR) have outpaced their ‘non-ESG’ Article 6 counterparts in the first nine months of the year.

Despite this, there are signs investors are growing weary of the ever-increasing product offering and complex reporting requirements that risk turning them off sustainable investment altogether.

James McManus, CIO of Nutmeg, said there is a risk to growing complexity, particularly for retail investors, with too much ESG product choice in the market.

“The problem when you have multiple providers offering similar index products is they have all got completely different thresholds, the nuances of which become very difficult for retail investors to understand,” he said.

As well as creating confusion for the end investor, it also creates challenges from a portfolio construction perspective as exclusionary metrics evolve to discard more and more stocks relative to the parent index.

A race to the bottom

While the market is growing at a significant speed it is important to note the differences between equities and fixed income, with the latter offering significantly less choice. Within equities, the proliferation of products over the past few years

has developed a “race to the bottom”, as index providers such as MSCI and S&P Dow Jones Indices (SPDJI) exclude a higher number of stocks relative to their parent index as ESG metrics and data evolves.

Lukas Ahnert, senior product specialist for Xtrackers core indexing at DWS, said this has both positives and negatives for ESG investors. “This choice is still highly attractive and makes fund selection simpler, because there are a lot of products out there that follow the same index, taking out minor nuances that issuers put on top.

“The disadvantage is from a portfolio construction perspective, reducing an MSCI world index from 1600 names down to 300 is interfering with your starting universe, you start to get idiosyncratic risks that will blow up and your ESG attribution becomes a lot more difficult.”

However, McManus said the race to the bottom is putting more pressure on clients: “Consistency is a key appeal of ESG index products, but we currently publish four sets of screens to demonstrate to clients the different levels of exclusionary metrics in similarly named indices.

“That just puts pressure on our clients’ understanding of ESG index products and can appear unnecessarily complex to the average retail investor.”

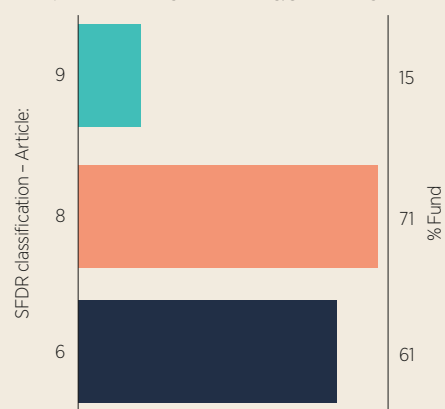
The growth in ESG ETFs is, at least in part, due to the supermarket approach offered by asset managers such as DWS and Amundi. Both have seen their ESG ranges expand hugely over the past couple of years through either launching new products or switching the indices on existing ETFs.

Amundi is targeting 40% of its product range to be ESG by the end of 2025 as it looks to offer an ESG ETF for every client allocation need.

“Clients have different needs in terms of their ESG assertiveness and risks,” Frederic Hoogveld,

“The growth in ESG ETFs is, at least in part, due to the supermarket approach offered by asset managers such as DWS and Amundi. Both have seen their ESG ranges expand hugely over the past couple of years”

CHART 2: ARTICLE 8 ETF LAUNCHES HAVE OUTPACED NON-ESG ARTICLE 6 ETFs IN THE FIRST THREE QUARTERS



Source: ETFbook

head of investment specialists and market strategy at Amundi, said. “They have to balance this risk compared to their benchmark, so we offer them products that suit their needs.”

Jack Turner, head of ESG portfolio management at 7IM, said this approach has been helpful to portfolio construction by “making it possible to build a portfolio of assets that are bespoke to whatever underlying objective you are trying to achieve”.

“The race to the bottom is good for fund selectors, it gives us lots of options and is keeping active managers on their toes,” he said. “You still have to be careful of what you find in the indices, what sort of tracking error are you exposed to and what factor tilts you have.”

Andrew Limberis, investment director at Omba Advisory & Investments, agreed choice was indeed a positive but added the complexity around comparing products meant certain ESG considerations could get lost in the mire.

“The choice aspect of ESG ETFs makes it very difficult to navigate,” he said. “Comparing the different approaches from issuers and index providers, particularly when you add different ESG providers, is certainly challenging.

“You will start using weighting other factors such as cost, securities lending and liquidity more heavily because you can just get lost in the ESG considerations.”

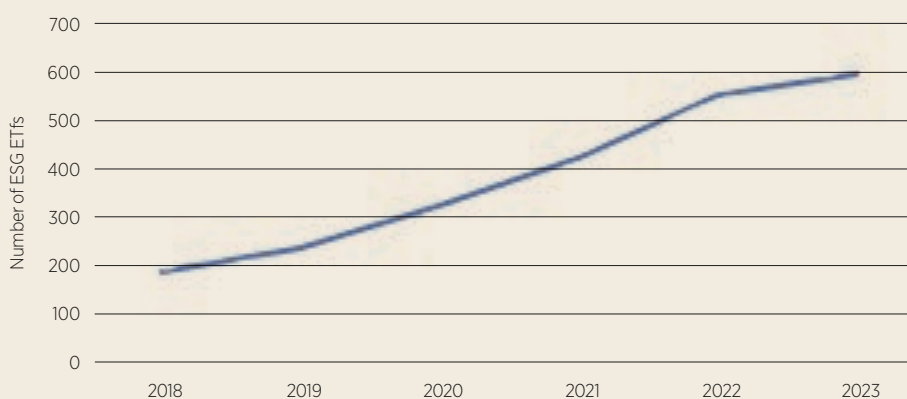
This is often compounded by products that are repackaged as ESG but look very similar to the parent index.

“There are a whole host of ESG-related indices and ETFs that are called something but have 99% overlap with the parent index and filter out five stocks, which is very poor,” Simon McConnell, senior portfolio manager and head of portfolio construction at Netwealth, said.

“It is up to the investment manager to do the research, but the client is at risk of misunderstanding or being overawed by the amount of choice in the market.”



CHART 1: ESG ETFs HAVE TRIPLED OVER THE PAST FIVE YEARS



Source: Morningstar Direct

Consolidation or standardisation?

Beyond regulatory developments such as SFDR in Europe, which many predict will not be fully operational until 2026, it is difficult to see how the landscape will become clearer for investors.

Some have suggested ESG ETFs could see consolidation in the future, delivering a clearer picture for fund selectors.

Limberis said he would like to see more standardisation in the space: “SFDR was an attempt at creating standardisation, but you need the next

level where the industry starts accepting different buckets of ESG,” he said. “It is about getting the right balance of standardisation and competition that will aid investor choice.”

Hoogveld added: “ETF issuers do not have exactly the same product exposure but philosophy speaking what they offer is a bit similar. I do not know if there will be consolidation, the ESG is complex because different investors have different values.

“The non-successful ESG ETFs will ultimately disappear, but this is the same for non-ESG ETFs also.”

Turner believes we could ultimately see some consolidation in the future, however, it will remain the investment manager’s role to do the correct due diligence.

“There is a lot of complexity because there are so many ETFs to look through,” he said. “The industry does potentially need some consolidation, but as a fund selector it is our job to do the due diligence.”

Theo Andrew is news editor at ETF Stream

ESG ETFs: Here to stay

Active managers have the ability to research companies and issuers to get a complete picture of their attitude to a range of ESG factors

Flows into ESG remain strong, although they have slowed so far this year relative to the very high levels seen in previous years.

With the 2023 Trackinsight Global ETF survey suggesting 30% of investors are looking to increase their exposure to ESG ETFs in the next two-to-three years, further positive inflows into ESG ETF strategies can be expected. However, the evidence suggests that the ESG ETF landscape may be changing, with important implications for investors and asset managers alike.

Active ESG strategies stand to gain in popularity

One of the most significant developments in the ETF industry in recent years has been the emergence of active management. Overall demand for active ETFs has risen from virtually nothing five years ago to year-to-date flows of nearly \$7bn – a 5% market share – by October 2023.

The emergence of active strategies is having a particularly large impact in the ESG ETF space. There has been a fall in demand for indexed ESG ETF strategies, which accounted for 23% of the total flows into UCITS ETFs in October 2023, down from a 49% share over the last 12 months. At the same time, Trackinsight’s survey has revealed that 68% of ETF buyers are currently using active strategies when considering ESG factors, with 28% only using active funds and 40% using active in combination with passive ETFs.

As more investors come to see the benefits of active management when targeting sustainable outcomes or when looking to include ESG considerations in their portfolios, demand for active ETFs could be set to grow further. Active managers have the ability to research companies and issuers to get a complete picture of their attitude to a range of ESG factors, compared to the

more blunt, exclusions-based approach taken by index providers.

Active stewardship, which allows managers to engage with companies and issuers on ESG issues, is also considered an advantage for active ESG ETFs by respondents to the Trackinsight survey, with 45% of ETF buyers considering the stewardship policy of an ESG provider as extremely or very important, while 60% regard active engagement as important when considering ESG factors.

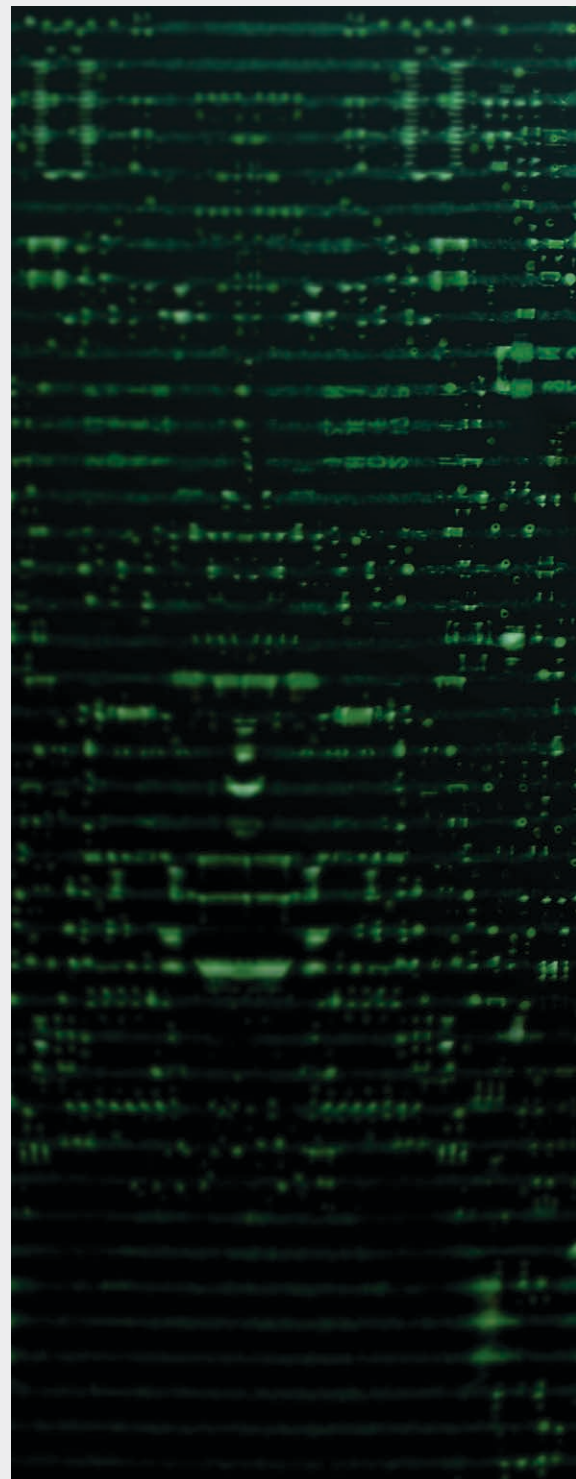
Fixed income on the march

Since ESG ETFs began to appear on the scene, equity strategies have dominated flows. In 2023, equity ESG ETFs have again recorded positive inflows, with global equity and US equity ESG funds proving most popular to the end of October. However, there has also been healthy demand for fixed income ESG ETFs this year. As of the end of October, fixed income ETF flows had reached \$54bn year to date, with fixed income ESG ETFs responsible for \$8bn of these flows. By comparison, equity ESG ETFs received flows of \$25bn.

This rise in demand for fixed income ETFs comes as investors have looked to increase their bond allocations to capitalise on more attractive yields, with some of the flows into the asset class being directed to fixed income ESG strategies. Concerns remain over the reliability of fixed income ESG data and the application of ESG analysis in security selection. However, as the Trackinsight survey suggests, active ETFs – when backed by rigorous ESG research and disciplined portfolio construction – can help to address some of the main challenges identified by respondents, including the consistency and transparency of ESG analysis.

The investment grade credit and developed government bond categories have been respon-

“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”



sible for the bulk of all fixed income ESG ETF flows. Interestingly, there has been little demand for emerging market debt ESG strategies despite attractive yields and the fact that a number of emerging market central banks have been ahead of the curve on interest rates. Specific worries over emerging market ESG data quality and few available strategies may explain this lack of interest, while emerging market debt exposure can also be achieved as part of diversified fixed income ESG portfolios.



Overall, however, 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.

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The sustainable investor for a changing world

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Bonds are back in town!

ETFs greatly simplify the construction and implementation of bond allocations

The period of extremely low interest rates since 2007 has seen a generation of investors grow up with an investment culture focused on equities and in particular tech stocks.

A broad range of market participants, and in particular younger investors, surfed the period using aggressive equity-based strategies. The ETF industry followed the trend, providing innovative solutions focused on equities. In the ETF universe, the range of bond funds on offer often lagged that of equity trackers.

Over the course of 2023, we have seen the start of what we expect to be the return of fixed income to its rightful place. But you ain't seen nothing yet!

At the start of the year, there was much talk of 2023 being the year of the bond. In retrospect, it was a little early. Central banks had more work to do in containing high inflation and financial markets were still pricing a new paradigm with quantitative tightening replacing quantitative easing. This process is now well engaged and fixed income is very much back in play.

ETFs - an essential part of the fixed income investor's toolkit

Index investing has, in our view, a major role to play in translating the broad and often fragmented fixed income investment universe into standardised exposures. These give investors access to those fixed income segments and risk profiles that fit their strategic asset allocation objectives. This is particularly important as bond markets reprice and dance to the tune of market fundamentals rather than those from the central banks.

“Since the spring of 2022, investors have been through an abrupt and brutal rebooting of the global bond market, taking us back to the level of interest rates that prevailed prior to the Global Financial Crisis in 2007/2008”

Our data suggests 2023 flows into ETFs through October were split almost equally between equities and fixed income with almost 400 new fixed income ETFs created globally in 2022-2023, of which 68 in Europe. Over the same period, the number of the new fixed income ETFs integrating sustainability criteria was 59 globally and 34 in Europe.

We believe that expansion and innovation in bond ETFs will continue to benefit from a double push via the catch-up with resurging client interest in interest rate products and remarkable growth and innovation in the global ETF industry.

Now is the time for ETF investors to look at bonds

The biggest story in financial markets in Q3 and through to the end of October 2023 was the unrelenting rise in the yields of US and German government bonds with maturities of 10 years or more. The 10-year US Treasury yield, at the heart of asset valuations within the financial system, surged to reach 5%, up from 3.80% at the start of the summer. It is the first-time yields have been this high since 2007.

Rising long-term bond yields came on the heels of the unprecedented rapid and substantial tightening of monetary policy implemented by the Federal Reserve and European Central Bank (ECB) as they scrambled to rein in the post-pandemic runaway inflation.

Starting in the spring of 2022, the Fed and the ECB raised their key interest rates by 525bps and 450bps, respectively. For now, they are on hold. But, having been bitten once by the inflation bug,





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they will not be inclined to lower their guard and cut policy rates until they have inflation well under control. Higher for longer is their new credo.

Bond markets return to normality....

Since the spring of 2022, investors have been through an abrupt and brutal rebooting of the global bond market, taking us back to the level of interest rates that prevailed prior to the Global Financial Crisis in 2007/2008.

While the pace of rising bond yields is startling by historical standards, the actual level is not. On the contrary, during most of the 20th century, a 4.5% yield on a 10-year US Treasury bond was considered normal, if not benign. What is most bizarre today, from a long-term perspective, is not that yields are rising, but that they were so low during the past decade.

An overshooting of bond yields?

With bond yields at today's levels, we are of the view that yields may have overshot, making fixed income securities potentially attractive – after this exceptional sell-off.

One of the most striking (and surprising) developments in the third quarter of 2023 was a significant rise in US real yields. Exhibit 2 shows just how far the five, 10 and 30-year benchmark yields have risen both since the Fed began tightening policy in March 2022, and in a broader historical context.

Our view is that the US Treasury nominal and real yields have overshot to the upside. Yields capitulated higher due to a combination of factors, including:

- US growth continuing to surprise to the upside

- Guidance from the Federal Open Market Committee that policy rates would be higher for longer and that recession risk in the US was receding
- Concerns over larger-than anticipated fiscal deficits leading to heavier longer-dated Treasury supply, as indicated in the Treasury's July Quarterly Refunding announcement (the refunding announcement on 30 October was more reassuring)
- Quantitative tightening
- Stretched overweight duration positioning among asset managers who had positioned for a US recession in 2023.

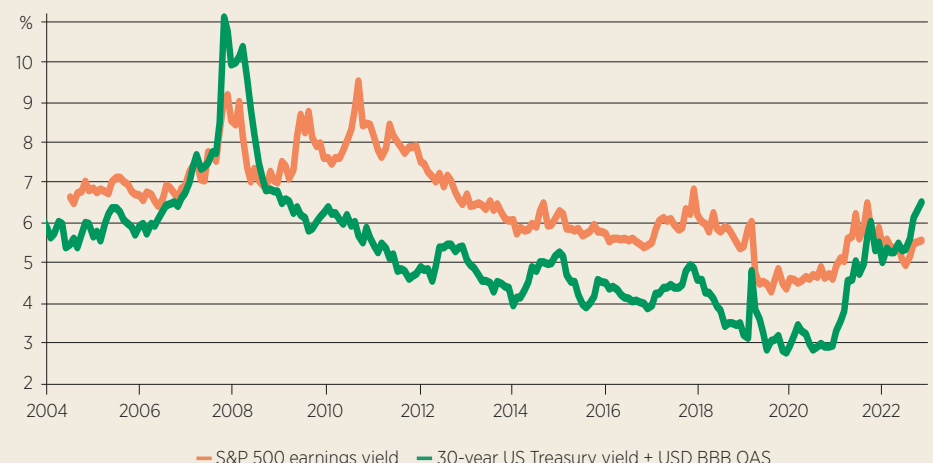
Our view is that the conditions for a topping-out of yields are now in place. Tighter monetary

policy should start to make itself felt, slowing US and European economies and encouraging flows out of other asset classes and into government bonds. A period of consolidation may be necessary along with a decline in volatility, but the absolute level of valuations represent, in our view, attractive entry levels.

Eurozone bonds stand out for us

The sharp rise in eurozone sovereign bond yields seems to us particularly hard to justify. The eurozone economy may well experience a mild recession in 2023 and will hardly grow by our estimates in 2024. Another external shock could easily tip the region into a deeper recession. Europe has

EXHIBIT 1: BOND RISK PREMIA EXCEED EQUITY PREMIA FOR THE FIRST TIME SINCE THE GLOBAL FINANCIAL CRISIS



Sources: BNP Paribas Asset Management, Bloomberg. Data as at 21 September 2023

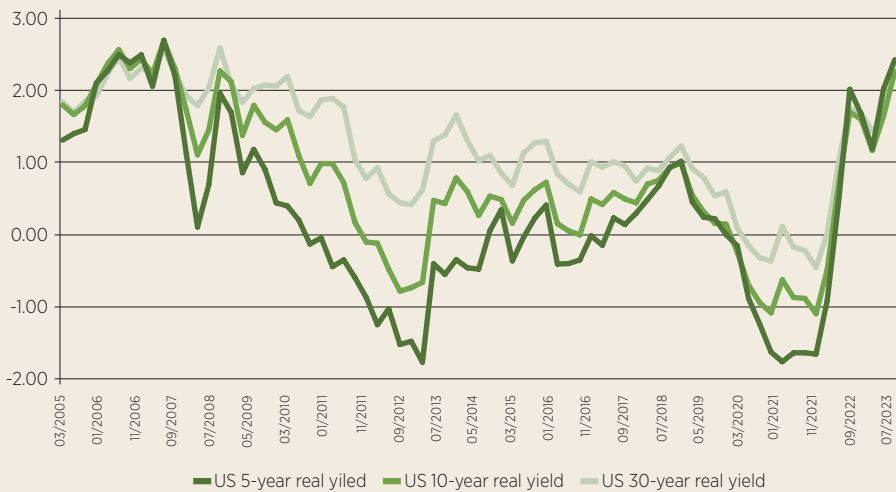


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EXHIBIT 2: REAL US BOND YIELDS ROSE MARKEDLY IN 2023 (IN %)



Sources: BNP Paribas Asset Management, Bloomberg, as of 16 October 2023

faced a similar increase in policy rates as the US, and a bigger jump in energy prices, but without the massive fiscal stimulus that put the vroom back into the US economy.

Despite the very divergent prospects for growth, the yield of the 10-year German bund has risen to close to 3%. Investors have, in our view, overreacted to fears that inflation might stay high. Recent data suggests the rate of inflation in the eurozone may decelerate more rapidly than in the US; in other words, the peak in eurozone inflation is clearly behind us. We see a significant risk that the ECB pursues a hard line, keeps policy rates high, exacerbating downside risks.

Integrating ESG criteria into bond ETFs

The increasing granularity of ETFs allows ESG investors to redefine their desired market exposure and understand the factors generating risk and return. They allow investors to take control of their fixed income allocations and ensure they reflect the desired ESG criteria.

At BNP Paribas Asset Management, we incorporate a framework to navigate and incorporate ESG criteria into our investment process for indexed investing. We look for index rule books that are aligned as closely as possible to our Responsible Business Conduct policy. We monitor and engage with index providers to adjust the methodology when we identify substantial discrepancies.

Index providers for our bond ETFs integrate proprietary ESG scores that are calculated using data from industry-leading data providers, for over 170 sovereign and 6,800 corporate and quasi-sovereign issuers. The score typically measures

an issuer's ESG performance and subsequently determines its weight in the benchmark.

Index providers apply negative screening for issuers involved in thermal coal, oil sands, weapons and tobacco, as well as issuers that violate the United Nations Global Compact (UNGC). The methodology may assign an overweight to green bonds to incentivise sustainable financing aligned with climate change solutions.

Last, but by no means least, BNP Paribas Asset Management's dedicated sustainability centre leads the ESG research effort for all our investment teams. Our stewardship team is recognised for its commitment and engagement. Within our fixed income investments, we believe the size of our holdings in corporate debt give us a voice with investee companies. We engage with issuers encouraging them to improve their sustainability practices, then tracking their progress and drawing the necessary conclusions as to their fit with our ESG policies.

As the regulations evolve, they may give a new momentum to sustainable investing by identifying with high granularity the principal adverse impacts on sustainability factors. We view this as an opportunity to capitalise on our in-depth understanding of these new sustainability-related requirements, and to innovate with a completely new offer of fixed income ETFs to be launched in 2024 which will apply our in-house ESG expertise to a non-ESG broad bond universe.

Conclusion

In 2024, we expect investors to further expand their fixed income allocations via index investing. Index investing enables investors to take po-

sitions rapidly and efficiently in those segments of bond markets where they see opportunities while considering ESG objectives.

By translating the vast, but fragmented, global bond market into standardised and efficient exposures, ETFs can greatly simplify the construction and implementation of bond allocations. We foresee an expansion in the range of fixed income indices, index funds and ETFs enabling a new generation of investors to allocate precisely and flexibly while including ESG criteria. The result will facilitate customised and nimble moves and allocations between segments with scope to adjust efficiently taking advantage of opportunities as the macroeconomic environment evolves and market fundamentals reassert themselves.

ETFs are a means to implement a fixed income strategy in all sectors of the bond universe rapidly and cost-effectively. For these reasons, we believe that fixed income indexing will expand further, reasserting its role as a core element in investors' portfolios.

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India: The emerging economic powerhouse

The South Asian nation has now surpassed China for population and GDP

India's prominence in the global economy has become impossible to overlook. In 2020, China had the fastest growing GDP of any major economy, and the largest population in the world. Fast-forward to 2023, and India has surpassed China on both counts. The IMF expects India to be the world's fastest growing major economy in both 2023 and 2024, and its population now stands at approximately 1.425 billion.¹

So, while China has long been hailed as the leading emerging market, there is now a case to be made that India is on the same trajectory. And

alongside this marked growth, we are also seeing the rapid development of the country's internet economy – the so-called “digitisation of India”.

To understand why India is believed to be digitising faster than any country worldwide, we need to delve into India's demographics.²

A digital population

India's explosive population growth is notable, but when examined closer, the reason for the country's digitisation becomes clearer.

Not only is India now the most populated country on Earth, it also has the largest “Gen Z” population by some margin.³ With a median age of 28 and around 65% of the population under the age of 35, India's vast population includes over 910 million millennials and Gen Z.⁴

This is significant, as these generations are cited as having a unique digital bond to the internet, growing up during the “Web 2.0” revolution since the mid-2000s, and being more likely to purchase smartphones or other appliances to bring themselves online.

On top of this, we are also seeing the rapid expansion of India's middle class. There are an estimated 423 million middle-class Indians – enough to “achieve economic security and be able to engage in discretionary consumption”.⁵

India's middle class currently represents around 31% of the population, but that number is set to rise to over 38% by 2031 (and 60% by 2047).⁶ This growth should lead to increased spending

power and further boost India's economy. When taken together, we have a massive population of tech-savvy millennial and Gen Z consumers, with an increasing amount of disposable income – ready to purchase their way to internet access.

The smartphone revolution

It is perhaps no surprise then, that India is seeing an unparalleled level of smartphone adoption. There are an estimated 7 million new smartphone users in India every 30 days.⁷ For context, back in 2010, India had around 34.18 million smartphone users. In 2023, there are over one billion – almost a quarter of the world's smartphone-using population.⁸

This is impressive, but India is still lagging the most advanced digital economies when it comes to percentage smartphone penetration.

But it is closing the gap. In 2023, smartphone penetration reached 71%, and it is expected to reach 96% by 2040.⁹ 5G rollouts driven by companies such as Jio and Airtel have seen substantial increases in subscribers to the network service, boosted by greater coverage in previously unconnected regions.

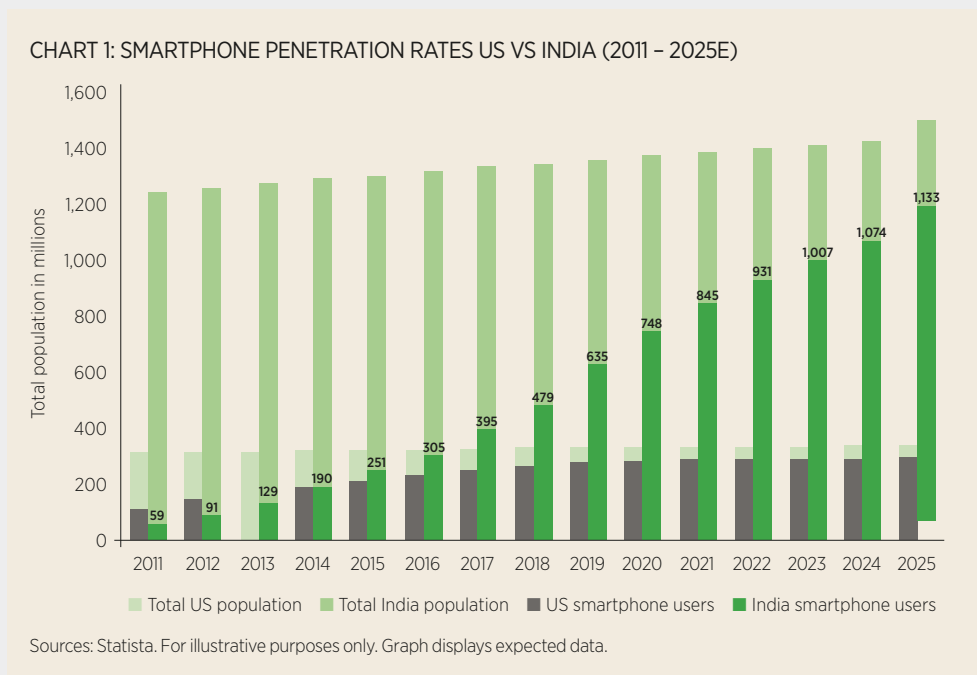
India has also developed digital public infrastructure (DPI), spearheaded by India Stack – a set of open APIs designed to bring India's population into the digital age. Since its rollout over the past decade, DPI has had unprecedented success and is credited with driving India's digital revolution. Businesses and governmental organisations have been given the tools to facilitate secure financial transactions, large-scale data transfer, verify identities and much more – online.

India's government backs digital

A vital element of India's digitisation is the government's recognition of its importance. In 2015, Prime Minister Narendra Modi launched the Digital India campaign, with the core goal of making its services available to citizens through expanded and enhanced online infrastructure and internet connectivity.

By 2018, India was adding 10 million daily internet users a month – the highest rate of internet-adoption worldwide.¹⁰ Most recently, at the 2023 G20 New Delhi summit, Modi spoke in favour of a “democratisation of technology” to bridge the data divide. He also expressed willingness to share India's digitalisation experience with partner countries.

Government backing is an essential component of the digitisation engine. This was exemplified earlier this year, when the CEO of Google (and its parent company, Alphabet), Sundar Pichai,



met with Modi – following which Google pledged \$10bn for India's digitisation fund.¹¹

Most of all, it provides reassurance to tech companies in India that their interests are protected, and that their success is integral to India's growth.

Exposure to India's digital revolution

Despite India's impressive digitisation, there is still a way to go. Investors, therefore, have a unique opportunity to capture this potential growth. INQQ Internet & Ecommerce ESG-S UCITS ETF (ticker: INQQ) aims to provide pure-play exposure to India's digitisation by capturing

companies benefitting from increasing online consumption by India's middle class.

INQQ is targeted, only including companies with majority exposure to internet and e-commerce activities in India. The ETF seeks to fix problems with broader India indices such as state-owned companies, overweight legacy bank and oil sectors and Indian companies in disguise generating most of their business in Europe or the US. Notably, the ETF provides ESG-screened exposure to India – the only ETF of its kind to do so.¹² Accordingly, the ETF is also classified as Article 8 under the Sustainable Finance Disclosure Regulation (SFDR).¹³

¹ <https://www.cnbc.com/2023/07/26/imf-raises-2023-economic-growth-forecast-for-india.html>
² <https://economictimes.indiatimes.com/tech/technology/indias-digital-economy-grew-2-4-times-faster-than-economy-in-2014-19-rbi-article/articleshow/96412446.cms>
³ <https://timesofindia.indiatimes.com/blogs/voices/understanding-gen-z-capturing-attention-and-loyalty-in-the-evolving-landscape/>
⁴ <https://bsfi.economictimes.indiatimes.com/news/fintech/millennials-at-forefront-of-online-finance-products-contribute-44-of-total-lending-report/97308820>
⁵ <https://www.ft.com/content/be53790c-ea16-4e5c-9410-bac189fb2636>
⁶ <https://economictimes.indiatimes.com/news/economy/indicators/how-the-middle-class-will-play-the-hero-in-indias-rise-as-world-power/articleshow/101608682.cms>
⁷ Statista; World Bank; EMQQ Global analysis
⁸ Statista; EMQQ Global analysis
⁹ Statista
¹⁰ https://www.business-standard.com/article/current-affairs/india-is-adding-10-million-active-internet-users-per-month-google-118062700882_1.html
¹¹ <https://timesofindia.indiatimes.com/india/google-to-invest-10-billion-in-digitisation-ceo-sundar-pichai-after-meeting-pm-modi/articleshow/101228411.cms?from=mdr>
¹² Confirmed within the ETF Database as of 31.10.2023.
¹³ https://etp.hanetf.com/Supplement___INQQ_India_Internet___Ecommerce_ESG_S_UCITS ETF.pdf

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Beyond Beta

Investigating the smart beta, factor & ESG investment revolution

The price of diversification

Investors must critically re-evaluate their asset allocation strategies

By Reza Vishkai

In a financial world where change is the only constant, some of the tried-and-true principles of asset allocation are ripe for reassessment. This is especially true for strategies aimed at capturing long-term expected risk premiums and those predicated on dynamic allocation strategies.

Recent performance data underscores this point. For instance, non-US, emerging markets and small-cap stocks have now underperformed large-cap US stocks by between 30% to 70% since the Global Financial Crisis stock market lows. Such a stark divergence in performance over such a long period challenges conventional wisdom and suggests it may be time for a rethink.

Modern Portfolio Theory: The rationale for diversification

The age-old adage “don’t put all your eggs in one basket” has long served as the cornerstone of diversification strategies. This principle was formalised by Harry Markowitz’s seminal work, which gave birth to Modern Portfolio Theory (MPT).

MPT argues that by diversifying across various asset classes or securities that are not perfectly correlated, investors can reduce portfolio risk without sacrificing expected returns. Essentially, it offers investors a “free lunch” of improved risk-adjusted returns.

The traditional approach: A mixed bag

For years, one of the primary lessons from MPT has been the diversification of higher-risk assets, such as equities. Investors and their advisors have generally diversified equity holdings by geography and market capitalisation. However, this

conventional wisdom has shown its limitations, especially for US investors.

Non-US stocks have lagged their US counterparts by significant margins for a very long time, partly due to the strength of the US dollar but mainly due to the outstanding performance of a narrow group of US-based but globally active companies. Similarly, small-cap stocks and emerging market equities, despite their promise of higher returns, have underperformed. This has left US investors who ventured beyond their domestic market or over-allocated to these “promising” segments sorely disappointed.

Conversely, European investors have found value in a more global allocation strategy, primarily due to the stagnation of their domestic markets. For them, diversifying into the robust US market has generally proven advantageous.

The Vanguard paradox

Vanguard – a leader in low-fee investing – strongly promotes disciplined, long-term investing with a preference for harvesting long-term risk premia and shunning dynamic asset allocation. This approach has served them exceedingly well as they have become one of the most dominant financial institutions, an extraordinary achievement for a non-profit.

Vanguard’s Target Date 2060 fund, designed for those planning to retire around the year 2060, highlights the potential drawbacks of their investment strategy. The fund allocates 90% of its assets to a broad spectrum of global equities including stocks from both developed and emerging markets across a range of market capitalisations. However, its performance significantly lags when compared to a simpler strategy focused on large-cap US stocks and US bonds.

The cost of inertia - sticking to outdated assumptions - can be high. It is time to question long-held beliefs that have not delivered for decades and consider more dynamic, data-driven approaches to asset allocation



For example, a consistent quarterly investment of \$10,000 in the Vanguard fund starting in the first quarter of 2011 would have grown to \$628,691 by the end of September 2023. In contrast, a portfolio with 90% invested in US large-cap stocks – representing over 93% of the US market – and 10% in US bonds – the US bond market size is over \$50trn – would have appreciated to \$876,474, a difference of nearly 40%. To close this substantial gap, the Vanguard fund would need to perform exceptionally well in the future.

The pitfalls of active management

Active managers, who often dynamically reallocate their portfolios across various markets segments with the expectation of outperformance, have also largely underperformed. This trend is reflected in Morningstar’s findings that only 24% of these managers beat their benchmarks globally over the past 15 years, as at June.

Unpacking the underperformance

This raises the question: Is the underperformance a cyclical phenomenon or is it indicative of a more profound shift in market dynamics? Several factors could be contributing to this underperformance. One possibility is that it is a long-term cyclical trend and we could see a reversal in the coming years. Market cycles often lead to periods of underperformance, followed by rebounds that could favour asset classes that have lagged.



Another explanation could be the increasing globalisation of economies. Companies that establish global dominance might be driving the persistent outperformance of large-cap US stocks. The ‘Magnificent 7’ tech giants, which have a significant global footprint, exemplify this trend. Their influence could be skewing overall market performance, making it appear as though US large-cap stocks are the only viable options.

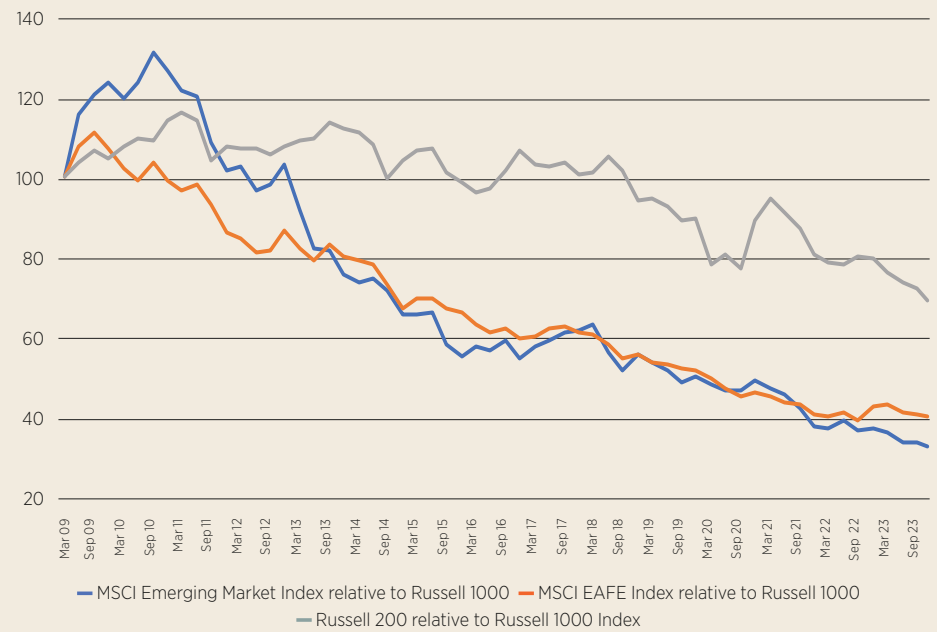
Additionally, the underperformance could be attributed to inherent risks in small-cap and emerging market equities that were previously underestimated. These asset classes may have already priced in factors like political instability, economic volatility, and less mature business ecosystems, thereby offering lower returns than anticipated.

Lastly, changes in monetary policy and trade relations could be influencing asset performance. Central bank actions, such as interest rate changes or quantitative easing, can have a disproportionate impact on different asset classes. Similarly, trade tensions or agreements can significantly affect international stocks, either hampering or boosting their performance relative to US equities.

Rethinking asset allocation: Adapting to a new era in strategy

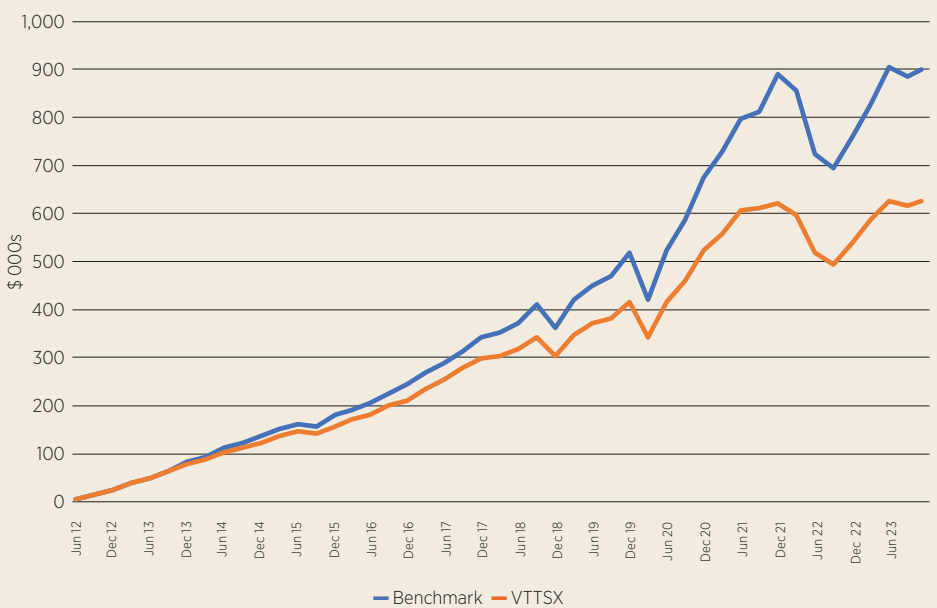
Given these complexities, investors must critically re-evaluate their asset allocation strategies. The

CHART 1: US OUTPERFORMANCE OVER PAST DECADE



Source: Parala Capital

CHART 2: VANGUARD TARGET RETIREMENT FUND VS MULTI-ASSET PORTFOLIO



Source: Parala Capital

cost of inertia – sticking to outdated assumptions – can be high. It is time to question long-held beliefs that have not delivered for decades and consider more dynamic, data-driven approaches to asset allocation.

Investors should consider adopting a more flexible asset allocation strategy that allows for adjustments based on evolving market conditions and individual risk profiles. This does not mean abandoning the principles of MPT but enhancing them with real-world insights. New metrics, learning algorithms and alternative data sources can offer more nuanced views of

risk and return, enabling smarter, more adaptive investment strategies.

While the principles of MPT remain valuable, their application needs a 21st-century update. The cost of inertia is too high, and the need for a more dynamic, responsive approach to asset allocation has never been more urgent. Standing still is the most significant risk of all.



Reza Vishkai is a founding partner at Parala Capital

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



The challenges of active ETFs

How can active managers consistently outperform the benchmark?

By Edoardo Mezza and Filippo Arena

What do famous names like Benjamin Graham, Peter Lynch, Warren Buffett and a few others have in common? They are all great active managers who consistently beat their benchmarks. Their performances have left a lasting mark on the history of financial markets and continue to fuel the appeal of active strategies. Unfortunately, these stars shine in solitude.

In the long term, passive-style solutions deliver significantly better results than active ones. Figure 1 shows that, over time, many active managers fail to outperform their benchmarks and, by extension, passive formulas. Even the best cannot maintain their lead for long. Why is the leadership so short-lived? An active manager can only outperform when others underperform. Although this point is controversial among academics, investing is a zero-sum game. Given a certain benchmark (which

has zero alpha), the positive alpha of the winners equals the negative alpha of the losers. Among the latter, the worst performers will exit the market. Eventually, as passive managers' assets grow, the space for active managers to succeed shrinks.

William Sharpe demonstrated: "Properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs. Empirical analyses that refute this principle are guilty of improper measurement."¹

So, the chances of active managers beating their benchmark become smaller and smaller as time horizons increase. This is nothing new. A statistical sample is more robust the larger it is. The well-known SPIVA study systematically demonstrates these aspects and helps to answer the question that many ask: is it worth investing in active rather than passive strategies?²

As Burton Malkiel said in *The Random Walk Guide to Investing*: "It is true that when you buy an index fund, you give up a chance to boast at

the golf course that you picked the best-performing stock or mutual fund. That is why some critics claim that indexing relegates your results to mediocrity. You are virtually guaranteed to do better than average. It is like going out on the golf course and shooting every round at par. How many golfers can do better than that? Index funds provide a simple, low-cost solution to your investing problems."

Nevertheless, beating the market and outperforming in both absolute and risk-adjusted terms remains attractive and continues to drive active strategies' commercial success.

Nowadays the new active ETFs – although they were quietly born some 15 years ago – are a steadily growing sector. This was inevitable and predictable given the flexible nature of ETF vehicles, which can host many types of strategies, not just the passive ones for which they were born.

How should an experienced ETF buyer react to this important piece of news? Should he remain sceptical, knowing that passive investing – with its lower tracking error – is more reliable? Or should he be clear-eyed about the opportunity to deliver better performance for his clients? A very tricky question indeed. The answer can only come from what we know about alpha, the

ingredient that, for better or worse, separates active from passive management.

Is alpha a compelling source of value for investors? The answer remains to be determined if we look at the last 50 years of academic research and empirical verification of the results.

Is alpha what investors want from their investments? Probably not, because the average person does not know what it is. Is it worth paying higher fees for something as unstable as sporadic? Probably not, because investing is not gambling.

The debate on these issues is lost in time as there is no scientific evidence to support it. Out-performance is an alchemy of luck and skill.

“Demonstrating the ability to outperform repeatedly is the only proven way to differentiate a manager’s skill from luck.”³

In short, active management is a game where players fail more than they succeed. Nevertheless, we cannot dismiss the idea of using active ETFs in portfolios altogether. That would be a wrong and potentially self-defeating choice. Based on this principle, no one would have invested in the funds of active managers who renowned for their exceptional skills and results. And none of these great leaders would have gone down in the history books as having beaten the market.

However, the integration of active strategies into passive terrain is now an undeniable fact of life. It is therefore up to the new active ETF issuers to prove that they can deliver the outperformance that justifies their approach (see Figure 2 and 3. Both charts refer to active and passive ETFs that are widely available in Europe. For each of them, data start from launch of the active ETF). On the other hand, ETF buyers need to study and monitor them carefully to take advantage of any opportunities. Objective assessments are becoming more and more crucial. For now, it is just a challenging task. Sadly, data are not yet statistically sufficient for careful selection. Luckily, the level of transparency in active ETF portfolios is increasing, at least in Europe, in line with current regulations.

If history is any guide, the introduction of new valuation models for the active strategies of these ETFs may be closer than we think, probably also thanks to the increasing use of artificial intelligence. A new challenge is now upon us and only time will tell.

¹ Sharpe, W., The Arithmetic of Active Management, The Financial Analysts’ Journal Vol. 47, No. 1, January/February 1991. pp. 7-9. Copyright, 1991, Association for Investment Management and Research Charlottesville, VA

² Lazzara, C., Shooting Hoops with Michael Jordan: An Allegory, Sep 29, 2022, Indexology Blog

³ Soe, A. M., and Poirier, R., Does Past Performance Matter? The Persistence Scorecard, S&P Dow Jones Indices, January 2018.

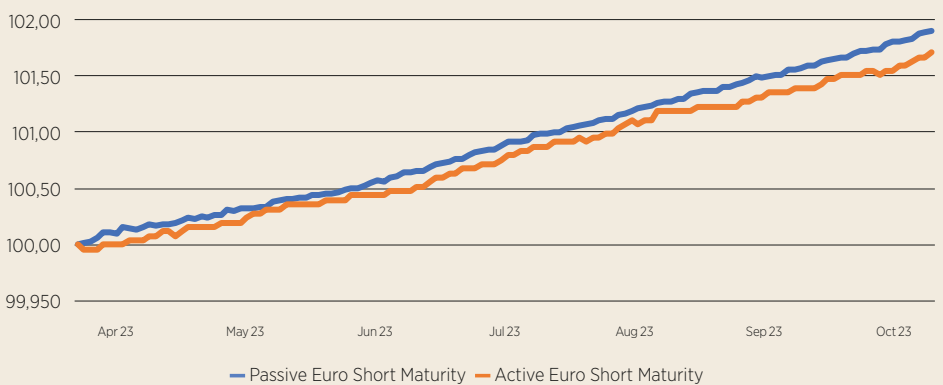
Edoardo Mezza is director and **Filippo Arena** is a private banker at Banca Patrimoni Sella

FIGURE 1: PERCENTAGE OF US EQUITY FUNDS UNDERPERFORMING THEIR BENCHMARKS (BASED ON RISK-ADJUSTED RETURN)

Fund category	Comparison index	3-year (%)	5-yr (%)	10-yr (%)	15-yr (%)	20-yr (%)
All domestic funds	S&P Composite 1500	75.15	91.33	94.66	96.99	97.43
All large-cap funds	S&P 500	69.84	90.81	93.53	96.90	97.21
All mid-cap funds	S&P MidCap 400	69.82	57.14	74.93	88.01	92.72
All small-cap funds	S&P SmallCap 600	63.20	57.71	83.18	88.35	91.92
All multi-cap funds	S&P Composite 1500	76.40	90.61	94.68	95.36	96.17
Large-cap growth funds	S&P 500 Growth	74.88	79.32	91.99	98.70	99.20
Large-cap core funds	S&P 500	72.46	85.43	96.14	98.09	98.64
Large-cap value funds	S&P 500 Value	93.73	89.72	90.61	85.60	88.04
Mid-cap growth funds	S&P MidCap 400 Growth	84.09	40.48	65.41	85.86	92.08
Mid-cap core funds	S&P MidCap 400	56.86	66.39	83.47	90.60	94.69
Mid-cap value funds	S&P MidCap 400 Value	76.47	64.15	77.61	85.29	86.60
Small-cap growth funds	S&P SmallCap 600 Growth	86.17	49.73	80.85	88.50	96.17
Small-cap core funds	S&P SmallCap 600	53.28	60.15	86.70	90.43	90.48
Small-cap value funds	S&P SmallCap 600 Value	55.88	61.86	83.33	87.39	83.18
Multi-cap growth funds	S&P Composite 1500Growth	72.88	84.12	91.19	97.74	96.58
Multi-cap core funds	S&P Composite 1500	79.49	90.17	96.67	94.98	95.10
Multi-cap value funds	S&P Composite 1500 Value	93.21	97.46	93.52	92.62	91.87
Real estate funds	S&P United States REIT	90.67	56.79	59.49	81.82	81.94

Source: S&P Dow Jones Indices. Data as of 30 June 2023

FIGURE 2: AN EXAMPLE OF HOW TWO FIXED INCOME ETFs, ONE PASSIVE AND ONE ACTIVE, HAVE PERFORMED SINCE THE SECOND'S LAUNCH DATE



Source: Source: Banca Patrimoni Sella. ETF names have been intentionally omitted.

FIGURE 3: AN EXAMPLE OF HOW TWO EQUITY ETFs, ONE PASSIVE AND ONE ACTIVE, HAVE PERFORMED SINCE THE SECOND'S LAUNCH DATE



Source: Source: Banca Patrimoni Sella. ETF names have been intentionally omitted.

Tactical ETF investing in China

Why it is important to hold shorter to medium-term time horizons when investing in Asia's largest economy

By Karin Wiederkehr and Stefan Wiederkehr

Our enduring fascination with China spans many years. Throughout our experience as investors, we have focused our asset allocation approach around global megatrends. This entails our commitment as long-term investors, advocating a buy-and-hold strategy for our client portfolios. However, in the realm of developing Asian nations, this approach has proven to be challenging, predominantly influenced by behavioural finance.

Consequently, we have opted for a more agile and responsive asset allocation in China, focusing on market timing and flexibility. This strategy entails a proactive approach to trading, leveraging continuous analysis of shifting market trends, economic indicators and investor sentiment. The overarching goal is to achieve superior performance within shorter to medium-term trading horizons.

By closely monitoring these dynamic factors, we seek to capitalise on market movements and fluctuations, making informed decisions based on the evolving landscape of economic indicators and prevailing investor sentiment. This method aims to outperform benchmarks and generate higher returns within relatively brief timeframes by capitalising on timely opportunities as they arise.

We perceive the stock market in China as having significant potential, buoyed by multiple favourable factors within the economy. With a population of 1.4 billion people, China offers a vast consumer base across diverse markets. Despite recent moderation, China's economic growth has remained rapid, outpacing other global economies.

The nation is strategically shifting its focus from high-speed growth to a more sustainable, high-quality economic model. This transition involves a pivot from an export-driven approach to emphasising domestic consumption and fostering

innovation to drive its economy forward. The expanding middle class in China has experienced a surge in spending power, resulting in heightened consumption and a sustained demand for a wide array of goods and services.

The widespread internet population in China has cultivated a strong preference for eCommerce and various social media platforms. As a global pioneer in eCommerce, online shopping has become deeply ingrained in Chinese consumer culture.

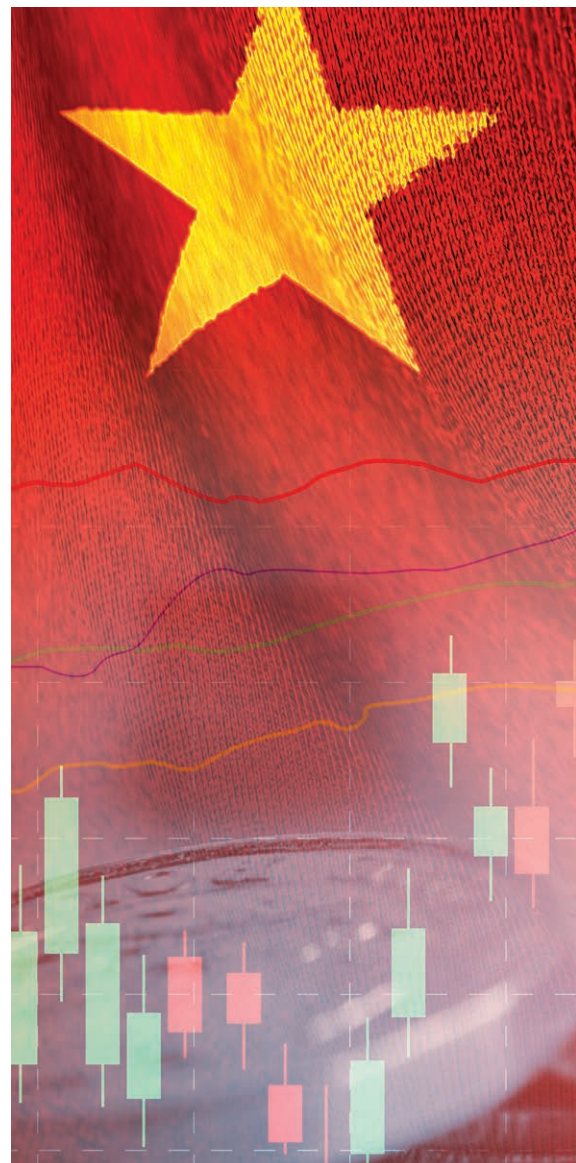
Notably, China hosts the largest population of internet users globally, with a significant preference for mobile-centric internet consumption. Moreover, the country has made remarkable advancements in technology and innovation, establishing itself as a leader in these pivotal domains.

Thriving industries

To seize this investment opportunity, we have strategically identified two thriving industries: eCommerce and luxury goods. The recent resolution of the Chinese government's regulatory actions on online retail, data privacy and consumer protection within the technology sector signifies a newfound stability. This sector is now seen as aligned with the government's focus on domestic consumption, reflecting a vital element of the latest Five-Year Plan.

This plan emphasises boosting domestic consumption, fostering technological innovation, promoting self-reliance, while still maintaining global engagement and inviting foreign investments. Although the post-reopening demand surge has been relatively slow, there is an eager anticipation for a significant resurgence in consumption. Additionally, the ongoing dialogue between the US and China hints at the potential for a normalisation of relations between these influential global powers.

This scenario may present an opportune mo-



ment to invest in the eCommerce and luxury goods sectors deriving revenue from Chinese consumers. The regulatory clarity and alignment with government policies, coupled with anticipated consumption growth and the potential for improved US-China relations, suggest a favourable environment for investments in these segments. The projections from the Brookings Institute regarding the rapid expansion of China's middle-class hold immense significance for the global luxury market. By 2027, an estimated 1.2 billion Chinese individuals are anticipated to transition into the middle-class, constituting a quarter of the global total.

As their incomes rise, there is a discernible shift in consumer preferences towards high-quality products and heightened service experiences. Chinese consumers are already displaying increasingly sophisticated and refined tastes. Their growing inclination towards unique and personalized products resonates well with the offerings provided by both the domestic and foreign luxury sector.

With the continuous growth and evolution of the Chinese economy, the luxury market is expected to assume an even more prominent role in the global

“Chinese consumers growing inclination towards unique and personalized products resonates well with the offerings provided by both the domestic and foreign luxury sector”



luxury industry. Major luxury brands stand to benefit not just from increased local purchases within China, but also from the avenues of cross-border eCommerce, buying agents, and sales through travel retail. Luxury brands that cater to the changing preferences and expectations of the Chinese market are likely to gain a significant competitive edge in terms of market share and financial growth.

Investment strategy

In order to implement this investment strategy of the above-mentioned sectors, we have opted for the following approach by utilising the identified ETPs below:

KRANESHARES CSI CHINA INTERNET ETF (KWEB) is an ETF that focuses on providing exposure to Chinese internet companies. Its investment objective is to track the performance of the CSI Overseas China Internet index. The ETF typically invests in companies that are domiciled in China, have a significant part of their business operations in China, or are listed on an eligible stock exchange and are classified as Chinese internet companies.

DIREXION DAILY CSI CHINA INTERNET INDEX BULL 2X SHARES (CWEB) is a leveraged ETF designed to provide daily investment results, before fees and expenses, that correspond to two times (2x) the daily performance of the CSI Overseas China Internet index. This ETF is different from KWEB in that it aims to achieve twice the daily return, which can magnify gains but also amplify losses compared to the underlying index.

KRANESHARES GLOBAL LUXURY INDEX ETF (KLXY) is an ETF that focuses on providing exposure to leading developed markets companies from global luxury-related sectors weighted by market capitalisation. Its investment objective is to track the performance of the Solactive Global Luxury index. The fund typically invests in global companies that operate across industries, including leather goods, jewelry, accessories, skincare, cosmetics, beverages, travel and super-car businesses.

This strategy allows us to seize these opportunities by actively investing in a highly focused mix of ETPs in line with our investment process, striving to achieve optimal results for our clients. In this context, it is imperative to

acknowledge this tactical investment approach might not align with the preferences of all investor types. It demands a comprehensive understanding of the thematic trend, a tolerance of concentrated risk, an ability to weather price fluctuations, and a resolute approach during periods of market turbulence.

While we have strong conviction in China's market potential, we advocate for a short to medium-term investment approach aimed at strategically securing profits. The goal is to capitalise on the current opportunities within a relatively shorter to medium-term timeframe, allowing for the realisation of gains and mitigating potential risks effectively. This strategy aligns with our emphasis on seizing the present prospects in China's market while being mindful of the need to secure profits within a defined and practical investment horizon.



Karin Wiederkehr and **Stefan Wiederkehr** are co-founders of IMP AG, a discretionary asset

manager based in Liechtenstein

Events

This section provides a summary of the latest ETF Stream events including webinars, roundtables and the Big Call series



Workshop review

ESG Investor Workshop 2023: Crunch time for ESG ETFs

ESG has faced a brutal 18 months with performance issues and geopolitical headwinds. However, with regulation reaching an inflection point and data improving, positivity is seeping back into the market

ESG ETFs are facing “crunch time” in Europe but it is premature to say the acronym is dead, as regulators attempt to create stricter and clearer definitions for asset managers and investors.

Delivering a keynote speech at *ETF Stream's* ESG ETF Investor Workshop 2023, Hortense Bioy, global director of global sustainability research at Morningstar, said there has been a huge amount of confusion around ESG across the industry but that ETFs have remained robust throughout.

“Despite all the criticism and uncertainty, ESG

funds have remained resilient in Europe,” Bioy said. “There is an unstoppable rise of ESG ETFs, every quarter they have gathered about 30% of all flows into ETFs despite representing 20% of all European ETF assets.”

She added the lack of consensus around ESG investing has meant it appealed to a wider range of investors but has also created confusion in the space.

“It is now time to be stricter and clearer with the definition because it is here to stay whether you call it ESG or something else.”

Europe’s Sustainable Finance Disclosure Regulation (SFDR) has faced increasing criticism for allegations it led to increased greenwashing among ETF issuers. The European Commission launched a full-scale review of SFDR in September in a bid to address these concerns and is likely to turn the disclosure regime into a labelling one.

“The European Commission is now thinking along the same lines as the Financial Conduct Authority (FCA) after its chaotic start,” Bioy added.

Year of the climate ETF

As well as regulatory uncertainty, ESG has also faced performance and political headwinds following the onset of Russia’s invasion of Ukraine in February last year and rising political tensions in the US.

Speaking on a panel discussing how investors are implementing ESG into their portfolios, Seifan Kasem, global head of ETF and indexing at HSBC Asset Management, said while 2022 was a “very difficult year” for ESG, 2023 has been the year of the climate strategies.

“In the majority of conversations we are having with clients, they do not want an aggressive [ESG] approach,” he said.



“They just want a low carbon exposure and they will implement this incrementally to see how their allocation changes.”

However, according to Sarah Williams, sustainable investment product manager at FTSE Russell, lower carbon strategies often came at the expense of broader ESG criteria after they found there was generally tension between low carbon tilts and negative ESG scores.

Another area investors have been targeting this year is active ESG ETFs. Ruairidh Hill, investment specialist, international equity group at JP Morgan Asset Management, said clients have been attracted by the potential to generate alpha while also being able to actively engage with the underlying companies.

”Just because you are investing to do good, does not mean you cannot invest to do well,” he said.

Better data, more inflows

One potential tailwind for ESG ETFs is the improvement of data used to calculate the underlying indices.

Stephanie Rowton, head of sustainability indices, EMEA at S&P Dow Jones Indices (SPDJ), believes data is improving in the space, particu-

“There is an unstoppable rise of ESG ETFs, every quarter they have gathered about 30% of all flows into ETFs despite representing 20% of all European ETF assets”

Hortense Bioy, Morningstar



“We are seeing a broadening trend within ESG. Over the last 18 months new product ranges have emerged, ESG screened was the first stage, now we are moving into areas such as factors, sectors and thematics as well”

Luka Ahnert, DWS

larly for valuable Scope 3 emissions those made by activities not controlled by a company.

“The narrative around Scope 3 data is outdated, it is much stronger than it was,” she said. “The industry will see more inflows with new data, be that regional or asset class level.”

She added improvements in data will also help in so far difficult to capture areas like biodiversity and certain Sustainable Development Goals (SDGs).

Despite the improvements, Williams said Scope 3 was still a nascent data set which creates issues for themes such as biodiversity. However, she warned of the risks of waiting until the data was perfect in areas that can make a difference in the fight against climate change.

“We need to decide if we need to move on these issues soon, we should not be waiting for [data] perfection,” she said.

In a separate panel discussion, Lukas Ahnert, senior product specialist, Xtractors core indexing

at DWS, said investors are becoming increasingly more comfortable with ESG data which is allowing for more complex product development.

“We are seeing a broadening trend within ESG as investors become much more comfortable with the data,” he said. “Over the last 18 months new product ranges have emerged, ESG screened was the first stage, now we are moving into areas such as factors, sectors and thematics as well.”

ESG bond issues

While ESG data quality might be heading in the right direction, investors must be wary of data gaps in areas such as fixed income, Kamesh Korangi, quant credit strategy at Anthropocene Fixed Income Institute, warned.

For example, he said the way index providers classify company revenues – using either the BIC or GIC classifications – may result in them

being included in some ESG indices and excluded in others.

Data providers can also be guilty of filling data gaps with estimated data which can result in bad actors entering the index. “Fixed income ETF data needs to be as good as the index rules,” Korangi said.

Despite this, Rowland added that we are seeing better data in the fixed income ESG space, one that is rising rapidly given the shift to a more attractive market for the asset class.

Jack Turner, head of ESG portfolio management at 7IM, added: “There have been a lot of ETFs launched in the fixed income ESG space recently, but it still has a lot of catching up to do with equities.

“There is still a debate around how much impact you can have with publicly traded equities, but with new issues around social bonds it is quite easy to tie your monetary outlay with underlying projects. That is what fixed income has over equities and investors are starting to wake up to that.”

ESG AUM DIFFERS DEPENDING ON HOW YOU DEFINE IT

\$35trn – Global Sustainable Investment Alliance

\$2.8trn – Morningstar

\$5trn – SFDR Article 8 and 9



ETF Stream Presents:

How can bond ETFs help navigate the rate-hiking cycle?

With many predicting the rate hiking cycle has peaked, bond ETFs have come back into sharp focus with questions around how to play the yield curve front and centre of investors' asset allocation decisions. How are investors using the wrapper within their portfolios? **Chair:** Tom Eckett, editor at ETF Stream

Investors are once again excited by fixed income following a period of rising interest rates and high inflation. However, with many anticipating the rate hiking cycle has peaked, fund selectors are now looking at how they can add duration exposure to their portfolio.

A barbell approach, taking both short and long-duration exposure, has been a popular play in recent months, but some are still wary about taking on duration risk.

ETFs can play a valuable role in this, as investors can pick their spot on the curve with relative ease. Be it through long-term asset allocation decisions or more tactical plays in a period of increased volatility, the ETF is an invaluable tool in this environment.

The role fixed income ESG ETFs can play is also a hot topic for investors, with the ability to make more of an impact through fixed income a key benefit for fund selectors.

As a result, the roundtable, in partnership with BNP Paribas Asset Management, assessed the current interest rate environment, how investors can play this with bond ETFs and the need for more product innovation that allows investors to make tactical allocations.

Market outlook

Dowds: We are moving back to a world that is much more normal. We have gone from a very abnormal period of 15 years to a point where we have a positive demand for real return. Fixed in-

come has become much more attractive because it is doing what it used to do, giving some return that investors can reasonably rely on over the maturity spectrum. We are not going back to a world of 2% interest rates.

Thompson: The theme of 2023 started as a predicted global recession which has been pushed out by greater economic resilience to central bank rate hikes. One of the reasons we are not overly bullish on fixed income yet is that US growth has been more resilient driven by fiscal stimulus which could be bad news for inflation over the medium term. Despite this initial resilience, the messaging of 'higher for longer' from central banks could mean slower growth going forward. Also, it is how governments reaction function to growth shift in this new fiscal landscape. Finally, the biggest prices sensitive buyer the Federal Reserve has been removed from the market.

Thomas: The market is deciding month by month whether the past two years have been an aberration or the norm and we keep getting data points supporting both sides. Fixed income is the most attractive asset class now because of the yields you are locking in. We are in a new world of higher inflation, higher rates and there is a degree of nervousness that markets might not be able to take this. There is a dynamic that what might be good for the economy (growth, wage gains for the lowest paid) could at the same time be bad for markets.

Pagni: The biggest threat to markets now is a second spike in inflation, but we do not expect to

see this in the US or Europe, thanks to the central banks' rate increases. Investors certainly believe central banks have done their job and see low inflation expectations over the next couple of years. There are also geopolitical risks, but this could be an opportunity for fixed income as investors seek a flight to quality.

Duration

Pagni: It is a period of great opportunities for fixed income investors. We have seen huge moves in rates and it is a good moment for both a short and long-term investment horizon – you can have both in the world of fixed income. We have a barbell approach to the curve at the moment. Some products allow you to take short-term duration and we recently launched an ultrashort ETF with less than one-year duration which is currently yielding 4.5%.

Thomas: It is attractive to have short duration but there are some really good ways to add duration to your portfolios. It is the rebirth of the 60/40 portfolio and if you were going to be a bit controversial you could reverse that.

Thompson: It has been tricky to scale into overtly long duration positions and I agree with short duration being quite attractive. TIPS across the curve look attractive with real yields where they are, so we have been adding inflation-linked exposure. Areas such as cash-plus strategies are also interesting because you are getting the cash rate plus the strategy returns with the current shape of the curve. We have been underweight duration for a long time so there will be a time to add when the US rolls over, particularly now that valuations have reset higher.

Dowds: In our balanced portfolios, our position has been quite conservative. For the best part of four or five years, we have been underweight fixed income, but now we are starting to rotate from alternatives into bonds because we do not necessarily need to rely on alternatives to generate a return.

Tactical allocations

Thompson: ETFs have become a great tool for multi-asset portfolios to add or subtract duration and efficiently remove spreads, and as such we have used them extensively. We have had some success in curve-based ETFs and we held a position in a two to 10-year yield curve steepener ETF, playing the fact the curve was heavily inverted in the US. In a world where volatility is high, having tactical ETFs is a fantastic thing so the ability to be more surgical in a hard-to-navigate environment would be welcomed.

Dowds: We were also big buyers of yield curve steepening ETFs and it has been terrific. It would be useful to have more products that give tactical flexibility to your asset allocation. Sometimes it can be difficult to work out how the bigger stuff is going to behave on a time horizon. I am a big

“One of the reasons we are not overly bullish on fixed income yet is that US growth has been more resilient driven by fiscal stimulus which could be bad news for inflation over the medium term”

Will Thompson, Pacific Asset Management

Meet the experts



Luca Pagni
head of fixed income ETF and index at BNP Paribas Asset Management



Patrick Thomas
head of ESG portfolio management at Canaccord Genuity Wealth Management



Will Thompson
chief sustainability officer, portfolio manager at Pacific Asset Management



Lorraine Sereyjol-Garros
head of ETF and index business development at BNP Paribas Asset Management



Stephen Dowds
CIO at Hay Hill Wealth

In association with



BNP PARIBAS
ASSET MANAGEMENT

The sustainable investor for a changing world

“We are moving back to a world that is much more normal. We have gone from a very abnormal period of 15 years to a point where we have a positive demand for real return. Fixed income has become much more attractive because it is doing what it used to do”

Stephen Dowds, Hay Hill Wealth



“The fallen angel space is something the ETF can do quite effectively. I would like to see more ETFs for investors that enable greater portfolio construction, but generally, the fixed income ETF market is very strong and innovation has been great already”

Patrick Thomas, Canaccord Genuity Wealth Management



KEY TAKEAWAYS

Thompson: It has been a monumental time for fixed income and I would argue a difference between the short and long-term prospects for the asset class. It is more important than ever now to be tactical with the view that over the long-term there has been a tectonic shift in real yields. Investors need to consider their credit exposure in a world where money is no longer free.

Thomas: We are all more excited about fixed income in terms of locking in returns. The ETF space has evolved a lot and given investors a lot more opportunities. From a sustainability perspective, it is underestimated just how useful ESG integration can be in fixed income.

Investors were surprised at the return of ESG-integrated fixed income versus traditional fixed income over the past couple of years.

Dowd: I would echo the usefulness of the ETF in being able to navigate the environment and their liquidity aspect. It is not always easy to play certain segments of the market, so the ability to execute through a liquid vehicle is important.

Pagni: The landscape has changed massively from a couple of years ago in terms of yield coming back to the forefront. The asset class is back to normal and investors can find value in asset allocation to fixed income. The last 18 months ETFs have shown their value, investors can trade the ETF even when there is no liquidity in the underlying.

fan of equal-weight strategies in the current environment too.

Thomas: The fallen angel space is something the ETF can do quite effectively. I would like to see more ETFs for investors that enable greater portfolio construction, but generally, the fixed income ETF market is very strong and innovation has been great already. There are plenty of ways to be tactical with your allocation with ETFs.

Pagni: Tactical trends are interesting but the issue from a product development perspective is you can be successful one day and two months later the trade is done. Ideally, we would have the complete tool kit for every potential strategy. The future of the ETF market is also going to be in active management. We are looking at moving away from the market cap weighting for individual bonds, while at the same time remaining closer in terms of beta exposure while protecting on the downside.

Fixed income ESG ETFs

Pagni: We are committed to ESG at BNPP AM. There are many ways to incorporate ESG into bond ETFs, either through ESG ratings alone or activity exclusion criteria, driven by investor demand and how it can be integrated into their portfolios. Investors can have a real impact in market terms on firms that do not comply with ESG.

Thomas: The choice of fixed income ESG ETFs has significantly evolved over the past five years in terms of product options and how you can build a diversified portfolio. The impact you can have has massively evolved, either with social impact bonds or screening at the issuer level. The ETF space is interesting from an ESG perspective because it gives you the ability to reduce your equity risk and diversify your portfolio.

Thompson: In a world where capital is more scarce debt markets are important for sustainable causes. We invest in green bonds, investible sustainable development bank bonds that are short duration and have been resilient.

“It is a period of great opportunities... We have seen huge moves in rates and it is a good moment for both a short and long-term investment horizon - you can have both in the world of fixed income”

Luca Pagni
BNP Paribas Asset Management





Event review

ETF Buyer: London 2023: Uncertainty awaits fund selectors

After one of the worst years for the 60/40 portfolio in the past century, investors now stare down the barrel of a new interest rate paradigm and a burning question; are bonds back for the long-haul?

ETF Stream's inaugural ETF Buyer London event for professional investors saw fund selectors debate how to allocate assets during macro uncertainty and keynotes from expert speakers including former Goldman Sachs

chief economist Lord Jim O'Neill and professor Andrew Clare.

The first panel discussed how to navigate the treacherous market environment, with speakers in consensus that fixed income allocations

are back in play, even if they are not yet ready to double down on duration.

Richard Champion, deputy CIO, UK at Canaccord Genuity Wealth Management, said the economic and monetary policy situation in the UK and Europe is "a lot more fragile" and he expects the Bank of England's hawkish messaging to give way to a pivot next year.

He added the Federal Reserve pausing rate hikes "seems totally logical", however, the past 2% inflation ceiling will look more like a floor in coming years, creating "a very different environment for making money".

Guy Foster, chief strategist, investment solutions at RBC Brewin Dolphin, suggested his team expect something "more akin to a hard landing" in Europe while resilience across economic indicators may allow the US economy to "motor on". Foster's team is currently "long gilts and relatively underweight US Treasuries",



“Perhaps I have misunderstood China for the past 30 years because I could not understand anything they have done over the past four years in terms of the lockdown aggressiveness ... If they do not shift, it will stay really bad”

Lord Jim O’Neill, ex-Goldman Sachs

favouring a “barbell” of very short and 10–15-year durations.

Regarding ETF usage, Canaccord “have been looking at an equal-weighted ETF” to achieve greater breadth on US equities “without taking too much specific risk”.

While utilising ETFs less than before, Foster said ETFs have played a role in implementing trades such as accessing the energy sector post-COVID-19 pandemic and the “compelling” value in subordinated financials can be “relatively easily” implemented using ETFs.

An accidental political alliance

Later, former Goldman Sachs chief economist Lord Jim O’Neill told attendees he had never intended his BRIC acronym to spark a political club in emerging markets.

He added the group’s recent decision to expand its membership may serve little purpose other than to have a diplomatic and trade bloc excluding the US.

Turning to China, O’Neill said the country had sown the seeds of its current economic downturn with demographic trends set in motion decades ago.

“The comparison to Japan in the 1980s and 1990s is not completely crazy, which probably has the worst labour force dynamics in the world,” he said.

“Perhaps I have misunderstood China for the past 30 years because I could not understand anything they have done over the past four years in terms of the lockdown aggressiveness which has deliberately weakened their own growth industries. If they do not shift, it will stay really bad.”

Portfolio construction for a new paradigm

Next, a panel uncovered whether portfolio construction orthodoxy still holds true in the new interest rate paradigm, even after the highly correlated freefall of 2022.

FIGURE 1: WORLD GDP POTENTIAL TO 2030

Economic region	1981-1990	1991-2000	2001-2010	2011-2020	2011-2019	2020-2030
World	3.3	3.3	3.7	4.1	3.6	3.5
USA	3.3	3.4	1.7	2.5	2.1	2.1
UK	2.8	2.5	1.7	2.0	2.1	2.0
Euro Area	2.4	2.3	1.2	2.0	1.2	1.5
Japan	4.6	1.2	0.8	1.0	1.1	1.0
China	9.3	10.5	10.5	7.5	7.5	5.0
India	5.6	5.6	7.6	7.5	7.1	6.5
Brazil	1.6	2.6	3.6	5.2	0.5	3.5
Russia	-	-2.1	4.9	5.4	0.9	3.0
BRICs	5.3	5.5	7.9	6.6	5.7	5.4
N-11	4.5	4.4	4.1	5.3	4.3	5.2

Sources: IMF, GS Global ECS Research and GSAM



“When IFAs and wealth managers protest and say they do not get paid to hold cash, I say nobody likes the individual ingredients of a carrot cake, but the end result is enjoyable”

Andrew Clare, Bayes Business School

Sir John Royden, head of research at JM Finn, argued the traditional 60/40 portfolio “stopped working” once interest rates fell to zero, but now rates have been hiked and there is scope for them to be cut, “we think the 60/40 is back and working well”.

He added his firm build portfolios for a range of macro scenarios including deep or mild recession or the ‘r-star’ scenario, which is when “the neutral rate of real interest hovers around the 3% level, driven by increasing levels of investment, greenification, reshoring, AI driving productivity and leaving us in a new world of slightly higher interest rates”.

Julian Howard, lead investment director at GAM, predicted the current spike in inflation and rates is “a blip” in the downward trend in real rates and real yields “over the course of centuries” and “in two years, we will be talking about something else”.

“If growth is suppressed, inflation will continue cooling and rates will come down too,” he continued. “It would be a shame to build a long-term portfolio around the news flow of the last six months rather than the last few centuries.”

Stefan Kuhn, head of ETF distribution EMEA at Fidelity International, noted the transformation in the role of ETFs within portfolios over the past three decades.

The veteran SPY ETF was originally created as a hedging tool following the 1987 stock market crash, he said. Decades later, ETFs span active management, ESG and granular fixed income exposures as instruments for savings and investments.

ETFs for all weather

Delivering the closing keynote, Andrew Clare, professor of asset management at Bayes Business School, posited three strategies for optimising

risk and returns that can be implemented using just ETFs and a spreadsheet.

The first, risk parity, involves risk-weighting portfolio components so their contribution to overall volatility would be broadly equal – for instance overweighting bonds in a 60/40, 2022 notwithstanding.

Using a rules-based approach capturing UK and emerging market equity, gold and commodity exchange-traded products (ETPs), Clare was able to outperform a 60/40 portfolio over the trailing two decades, with lower volatility.

Next, he illustrated a momentum strategy using 25 commodity indices, identifying and holding the top five performers over the past year and rebalancing monthly. Clare noted this strategy “enhances returns but also the drawdowns”.

The final strategy, trend-following, involved allocating to the desired assets in a positive trend and holding cash in place of the desired assets in a negative trend. Clare noted overlaying a month-on-month trend following filter onto a 10-strong momentum basket saw returns jump from 426% to 1026% over the past 23 years.

“When IFAs and wealth managers protest and say they do not get paid to hold cash, I say nobody likes the individual ingredients of a carrot cake, but the end result is enjoyable,” Clare said on his trend-following strategy.



ETF Stream Presents:

Emerging markets: An attractive opportunity among darkening clouds?

A turning macro tide may spell a brighter decade for emerging markets, but fund selectors face the difficult task of segmenting opportunities from risks and implementing these views within a portfolio. **Chair:** Tom Eckett, editor at ETF Stream

Emerging market ETFs remain in focus for fund selectors amid high concentration in US equities and the potential for a weakening US dollar over the long-term.

However, with country risk being a more prominent driver of volatility than sectors or factors, questions arise over how to segment developing economies from the contrived 'EM' grouping, as well as red flags to watch for regarding political risk, whether institutions are facilitating free trade and the challenges of implementing EM exposures within a portfolio.

Front and centre in these discussions is the world's second-largest economy, China, with fund selectors divided on how – or whether – to allocate to the market.

Views on emerging markets

Saurabh: In the current macro environment with recessionary concerns and the consensus that interest rates are going to stay higher for longer, investors are still hunting for growth and EM are still a beacon of light. When it comes to EM, some of our clients have stopped treating it as a monolith. Some investors may not have the operational expertise to do this but geopolitics and overweights to some countries are driving demand for a more selective EM view. EM allocations are also a diversifier, with low correlation with US. Pairwise, correlations between EM countries are also lower than between developed markets.

Sekar: The headline EM benchmark has had a tough time vis a vis its developed market peers over the last few years due to its large allocation to China. This is illustrated by the +70% performance differential between Chinese and US equities over the past three years. While we have a cautious stance on emerging market equities currently, there are a few specific regions on our watchlist. We are comfortable being neutral Chinese equities until further policy support comes through. Both Mexico and India are better insulated from a China slowdown. Additionally, both countries are set to benefit from a growing labour force and increased productivity from capex spends. We would like to see Indian equity valuations compress and the Mexican Peso to soften for the regions to become more attractive. Taiwan could be an interesting tactical opportunity with signs the semiconductor cycle is bottoming along with its central bank having the capacity and willingness to defend its currency. All three of these countries have elections next year posing different levels of risk.

Scott: We look at EM in two components; as China-specific and then grouping others as 'trader economies'. Ultimately, China has been a primary driver of EM Asia and western economies being a driver of other economies. Latin America is strong at the moment, owing to central banks being proactive and reaping the rewards of that, as well as 'friend-shoring' with the US. Meanwhile, the

China reopening story has fizzled out and what we are seeing domestically is not conducive to having a strong tactical view.

John: Emerging markets are very diverse so one must start with capitalisations and index weightings. China is 30% of MSCI EM, India is 16%, Taiwan is 15%, South Korea is 12%, so four countries account for 73%. These countries do not have a lot in common, with the latter pair being advanced countries in terms of technology and economic development.

We have been of the view that on the whole EMs are not going to do well, however, we would look at them on a case-by-case basis. We have not liked China for some time owing to the enormous political risk. India is a better prospect and starting from a much lower GDP per head.

Philip: We start off with a zero allocation to EM and only go there if we determine that it is attractive. There are good reasons to think some EMs could do well in the long-term, but the current trade dynamics with the US need to be reshaped so that consumption in emerging markets can rise and US imports reduce. A falling US dollar is generally good for EMs, boosting their global purchasing power but in the short term can be disruptive for exporting industries. The key problem becomes how to benefit from the stronger economic growth as looking at the broad EM index over the past 15 years, there has been very limited earnings growth despite continued economic growth.

Fotios: Supply-demand dynamics between EMs other developed markets have changed a lot. Approximately a third of revenues of Europe-listed companies are being derived from EMs. From an implementation perspective, by looking at revenue streams, you can take advantage of this implicit dependency by investing in European companies reliant on EM demand, without incurring as much of the political risk.

Rob: We run strategic asset allocation and we do not tactically tilt. However, we do factor tilt in the allocations and asset classes. When creating a strategic asset allocation using multi-year expectations, you need to have conviction in your expectations, and this is especially true in EM. In our highest risk profiles, we have a large allocation to EM, but it does drop off quite quickly in lower risk profiles. The reason for a larger allocation in higher risk solutions is that EM is the asset with the highest expected return over a full investment cycle.

How to allocate to China

Saurabh: We have been discussing EM ex-China, but it is worth noting this is not just from a risk perspective, it is also about portfolio construction and we see a similar thing with clients wanting to separate their US equity exposure with the MSCI World ex-US index.

“There are good reasons to think some EMs could do well in the long-term, but the current trade dynamics with the US need to be reshaped so that consumption in emerging markets can rise and US imports reduce.”

Philip Smeaton, Oberon Investments

Meet the experts



Fotios Kassianidis
executive director, head of indexed investments and solutions, MSCI



Sekar Indran
senior portfolio manager, equities at Titan Asset Management



John Redwood
chief global strategist at Charles Stanley



Saurabh Katiyar
executive director, head of index solutions research, EMEA, MSCI



Scott Gardner
investment strategist at Nutmeg



Philip Smeaton
head of investments at Oberon Investments



Robert Starkey
portfolio manager at Schroders

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KEY TAKEAWAYS

John: The different components of the EM index vary greatly and we need to appraise their risks and behavioural characteristics accordingly. Political risk is a particularly strong variable in these countries where the free and liquid market approach is not yet fully developed.

Fotios: Country selectivity matters, but we need to go beyond this and dig into the data on valuations and structural biases towards particular sectors. Granularity is more relevant than ever for EMs.

Philip: EMs are clearly on everybody's radar but our methods for evaluating and implementing the opportunity set differ greatly. Developed markets have done well, mainly because the

US has done well, but things like that do not go on forever and you need to appraise the opportunities on offer.

Rob: There is the view that EMs are fragile, but they are not as fragile as many think as they have evolved over time. There will likely be increased volatility, especially in smaller EM markets, but this increased uncertainty is generally rewarded with a higher expected risk premium. However, you need to manage risk appropriately and stay the course to reap the benefits. The EM silver lining could be an EPS pick-up supported by a macro tailwind.

Sekar: Selectivity within emerging markets is key with geopolitical risk on the rise, a slew of upcoming elections, differing growth/inflation mixes between countries and respective

policy responses. Beyond EM, frontier markets could also offer uncorrelated sources of alpha. Vietnam and Bangladesh are two nations with promising growth potential and with time, we should see greater access to their capital markets.

Scott: Granularity is welcomed in EM, especially within the ex-China space. We remain somewhat pessimistic on China but overall, there are some positive signals from EM.

Saurabh: China-Taiwan has the potential to be a massive geopolitical event but it is hard to price in. We are also interested in the debate between market cap versus alternative data sets such as economic exposure and it is interesting these are already being considered by asset allocators.

“ETFs can be an effective tool to gain your desired emerging market exposure, whether it’s for long-term strategic allocations or shorter-term tactical positioning”

Sekar Indran, Totan Asset Management

Scott: We look at China by splitting it into domestic versus external and that is important. About 51% of its GDP is still manufacturing focused so it is still very much dependent on global trade flows despite the current efforts from the Chinese Communist Party (CCP) to shift to more domestic consumption. We look at broad China rather than getting into the granularity of A-Shares unless there is a clear opportunity on a tactical basis.

Rob: Greater China provides opportunities despite recent discussions by some that the market is uninvestable, especially when we consider some less direct markets that are related, such as Vietnam – albeit this is classified as a frontier market country. China’s R&D spending in technology as a percentage of GDP is higher than the US, while the number patents in this space are double the US, which is expected to benefit growth in the long-run. If you want to get exposure to this investment spending, especially while there is a trend de-equitisation and increasing stock concentration in the rest of the world, you will at least want to consider EM and China.

John: China is the most politically-managed market at a time when the world is generally going to models that are much more based on government intervention in business, with lots of windfall taxes, subsidies, directions and price controls. It is a very dangerous place to predict even though the government can say what it means, because you have this clear, autocratic control in the hands of one person and the team he appoints.

Phillip: China has produced some incredibly successful companies such as Tencent and Alibaba which have made wise investments and are leading in innovation. Their recent fall from grace highlights the inherent political risk. The state decided these companies were making too much money and effectively implemented a 10% haircut to profit margins. Extrapolate this to the rest of the Chinese market – so what if they come up with something great? Are they allowed to keep the profits from it? Taking risk is only sensible if you are allowed to keep the profits.

Sekar: We currently have a benchmark-neutral allocation via offshore listed Chinese equities which tend to be more impacted by foreign investor flows (the region is massively under-owned relative to history). There have been some small green-shoots in developments between US-Chi-

na relations, but we need to see more meaningful policy support, particularly for the property sector in tier 2 and 3 cities before we increase conviction. The third plenum is a key event we’ll be closely watching for greater clarity on policy direction at a national level.

How are you using ETFs to play emerging markets?

Scott: Overall, we are neutral on our EM allocation and look to use ETFs tracking broad EM IMI and SRI benchmarks as well as an MSCI EM consumer growth index within our thematic sleeve. With the latter index, you get a lot of second order and third order effects, with companies that are actually in Europe such as LVMH.

Sekar: ETFs can be an effective tool to gain your desired emerging market exposure, whether it’s for long-term strategic allocations or shorter-term tactical positioning. Over the years, we’ve held broad market cap EM positions, smart beta as well as numerous country-specific emerging

market ETFs which have positively contributed to our portfolios’ performance.

Rob: The bulk of our business is done via third-party platforms, which creates the hurdle of accessibility, with many platforms not offering ETF options to select. In some instances when they are available, they often come with minimum trading costs which end up being a large drag on performance for smaller investment accounts. We do use ETFs in our pooled vehicles as this is both easier and more economical for our investors.

Phillip: For simple broad EM exposure, we would probably opt for a single EM ETF but would prefer not to have China in there. If China were to invade Taiwan – aside from the secondary effects which are impossible to predict accurately – we would probably be looking at all the Chinese assets being confiscated or priced to zero just as Russian ones were last year. Country ETFs are attractive where you have a country which is strengthening their institutions and improving investor protections, that generally creates a good tailwind for investments.

John: On the discretionary portfolio and fund side, we typically hold emerging market exposure through ETFs, and maybe supplemented by specialist management funds. We are a broad church of passive and active. Some higher risk discretionary accounts may also use single country ETFs, where we felt it was appropriate.



Data dashboard: November 2023

Investors rotated out of short-duration US Treasury ETFs this month amid forecasts the Federal Reserve will cut rates towards the beginning of the next year

Data provided by



Data as at 17 November

TOP PERFORMANCE

Ticker Return

TOP 10 BEST PERFORMING ETFs

Electric Vehicle Charging Infrastructure	ELEC	23.36
HSBC Nasdaq Global Semiconductor	HNSD	14.49
Global X Genomics & Biotechnology	GNOM	14.37
iShares MSCI Global Semiconductors	SEMI	14.34
Global X Cloud Computing	CLO	14.22
iShares S&P U.S. Banks	BNKS	13.92
Franklin Metaverse	METE	13.81
VanEck Semiconductor	SMH	13.80
iShares UK Property	UKP	13.61
Deka STOXX® Europe Strong Value 20	EL4D	13.09

TOP 10 WORST PERFORMING ETFs

INQQ India Internet & Ecommerce ESG-S	INQQ	-18.78
Lyxor S&P 500 Vix Futures Enhanced Roll	VOOL	-14.48
Swisscanto ETF Precious Metal Physical Palladium	JPAGA	-8.06
UBS ETF (Ch) - Palladium	PLUSA	-7.90
ZKB Palladium ETF	ZPAL	-7.51
BNP Paribas Easy Energy & Metals Enhanced Roll	GSGE	-6.26
Amundi Bloomberg Equal-Wght Commodity Ex-Agriculture	COMO	-6.26
ZKB Platinum ETF	ZPLA	-5.21
iShares Diversified Commodity Swap	ICOM	-5.15
Market Access Rogers International Commodity Index	MBSA	-5.00

INFLOWS

OUTFLOWS

Name	Ticker	Inflows (\$m)
iShares Core € Corp Bond	IEAC	1,711.52
Amundi MSCI USA ESG Climate Net Zero Ambition CTB	DNRA	1,142.82
SPDR® S&P 500®	SPY5	909.68
SPDR® S&P 500® € High Yield Corp Bond	IHYG	628.64
Vanguard S&P 500	VUSA	574.15
SPDR® S&P 500® Core MSCI World	SWDA	556.59
UBS ETF MSCI USA Socially Responsible	UIMP	495.88
Amundi MSCI USA ESG Climate Net Zero Ambition CTB	USAC	475.28
SPDR® S&P 500® J.P. Morgan Em Local Govt Bond	SEML	449.55
SPDR® S&P 500 ESG Leaders	500X	382.24

Name	Ticker	Outflows (\$m)
PIMCO US Dollar Short Maturity	MINT	-1,029.71
Xtrackers II US Treasuries	XUTE	-494.83
iShares J.P. Morgan \$ Em Bond	EMES	-474.62
Xtrackers CSI300 Swap	XCHA	-410.67
Xtrackers S&P 500 Equal Weight ESG	XZES	-377.88
L&G Europe ESG Exclusions Paris Aligned	RIEU	-358.40
iShares € Govt Bond 1-3yr	IBGS	-323.56
iShares Digital Security	LOCK	-274.84
iShares \$ Treasury Bond 1-3yr	IBTS	-260.37
iShares MSCI USA SRI	SUAS	-240.65

NEW LISTINGS

Name	Fund ISIN
Global X S&P 500 Annual Buffer UCITS ETF - USD Accumulating	SABPLN
Global X S&P 500 Annual Tail Hedge UCITS ETF - USD Accumulating	SAHPLN
BNP Paribas Easy ECPI Global ESG Infrastructure UCITS ETF	XU61GY
BNP Paribas Easy ECPI Global ESG Infrastructure UCITS ETF - USD	BJLBGY
L&G Emerging Markets ESG Exclusions Paris Aligned UCITS ETF - USD ACC	RIEMLN
AXA IM USD Credit PAB UCITS ETF ACC USD	AIPUGY
Amundi MSCI North America ESG Climate Net Zero Ambition CTB UCITS ETF ACC	NRAMFP
Amundi MSCI North America ESG Climate Net Zero Ambition CTB UCITS ETF DIST	WEBEGY
Amundi MSCI USA SRI Climate Net Zero Ambition PAB UCITS ETF EUR Hedged	USRIHIM
Amundi MSCI USA SRI Climate Net Zero Ambition PAB UCITS ETF ACC	USRINMM
Leverage Shares Brent Oil ETC	IBRNLN
Leverage Shares WTI Oil ETC	WTILN
Leverage Shares Natural Gas ETC	NGLSLN
Leverage Shares Copper ETC	CULSLN
Leverage Shares -3x Short ARM ETP	AR3SLN
Leverage Shares 3x Long UBS ETP	UBS3LN
Leverage Shares 3x Long ARM ETP	ARM3LN
Leverage Shares -3x Short UBS ETP	UB3SLN
Leverage Shares Cordillera Core Balanced Strategy ETP	CODLNL
INQQ India Internet & Ecommerce ESG-S UCITS ETF - ACC	INQQLN
Amundi MSCI USA ESG Climate Net Zero Ambition CTB UCITS ETF ACC	USACFP
Amundi MSCI USA ESG Climate Net Zero Ambition CTB UCITS ETF DIST	LYYBYG
UBS (Lux) Fund Solutions - MSCI United Kingdom UCITS ETF (Hedged To Eur) A-DIS	CHSCGY
UBS (Lux) Fund Solutions - MSCI United Kingdom UCITS ETF (Hedged To USD) A-DIS	UKUSDDSW



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Time: 13:00 – 17:15

Location: Borsa Italiana



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