AN ETF STREAM PUBLICATION // WWW.ETFSTREAM.COM // Q4 2020

BEYOND BETA

INVESTIGATING THE SMART BETA, FACTOR & ESG INVESTMENT REVOLUTION

ESG IN FOCUS

Investigating the green revolution

In this issue

About us

David Stevenson

David trained as an economist before moving into financial journalism where he has written about investing and finance for many years. David is CEO and Editor in Chief of AltFiNews and is also a columnist for the Financial Times (the Adventurous Investor), Investment Week and Money Week. David is an experienced media entrepreneur (he's set up a number of online media companies focused on online TV and viral videos) and investment expert of retail repute.

David Tuckwell

David is an Australia-based journalist who covers exchange traded funds and fintech. He formerly worked in the ETF industry in London. In another life he was a top national Tetris player.

Tom Eckett

Tom joined ETF Stream as a senior writer in March 2019 before being appointed deputy editor in January 2020. He started his career at Investment Week in August 2016 as an asset management correspondent covering ETFs.

Editorial

Hello and welcome to *Beyond Beta* – the one and only magazine dedicated to smart beta and quantitative investing. This issue focuses on the dramatic rise of environmental, social and governance (ESG) investing over the past 18 months by analysing key areas of the market.

ESG ETFs in Europe have shown remarkable resilience during the coronavirus turmoil pulling in €730m in March despite ETFs suffering their worst monthly outflows on record, according to data from Morningstar. This stat highlights the structural shift to more sustainable assets taking place in the market and highlights the belief investors have about investing sustainably through the ETF wrapper. Overall, ESG ETFs have seen record net inflows of €22bn this year with assets doubling to €54.2bn year-to-date.

Not only have ESG ETFs continued to see record-breaking inflows but performance has remained strong. Highlighting this, the MSCI World SRI index – which takes the top 25% highest scoring ESG companies from the MSCI World – has outperformed its parent index by 4.25% so far this year, as at 30 October. Over a longer time horizon, the MSCI World SRI index has delivered annualised returns of 9.7% over the past decade versus 9.3% for the MSCI World. While it has not been proved focusing on ESG metrics can improve the risk-return profile of portfolios, the outperformance since the Global Financial Crisis has certainly been critical in driving inflows into ESG ETFs along with the rise of a more socially-conscious investor set.

Along with a deep dive into whether investors can have an impact with ETFs, a look at whether investors should be including gold in sustainable portfolios is also assessed in this issue which begins with a market overview, looking at the best performing and newly listed smart beta ETFs from around the world. It then moves to a series of interviews and essays with top experts from across the quantitative investing landscape. Highlights include an interview with BlackRock's James Gloak on the rise of ESG ETFs, research from Steven Goldin, managing partner and co-CIO at Parala Capital, who analyses how ESG ETFs with the same exposure behave differently across the business cycle while WisdomTree's Pierre Debru analyses the benefits of the quality factor during both bull and bear markets.

As always, a quick note from us on definitions. We define smart beta as nonmarket-weighted rules-based ETFs. For us, smart beta ETFs do not have to be index-tracking. What matters is that they meaningfully deviate from the market weighted portfolio, while trading according to a set of rules. (Where those rules, preferably, have some basis in peer-reviewed literature).

This means, for example, that actively managed ETFs with portfolio managers making ad hoc trades are not smart beta for us. While index tracking ESG ETFs that make consistent far-reaching exclusions can qualify as smart beta. Quantitatively, we would expect smart beta ETFs to have a correlation coefficient less than 0.95 with their broad market benchmarks. Smart beta ETFs that demonstrate a correlation higher than this, for us, count as "closet trackers".

Tom Eckett, deputy editor, ETF Stream

Beyond Beta is published by

Address
55 Basinghall Street
London EC2V 5DU
UK
E: info@etfstream.com
W: www.etfstream.com

Publisher
David Stevenson
E: david@etfstream.com

Editor
David Tuckwell
E: david.tuckwell@etfstream.com

Deputy editor
Tom Eckett
E: tom.eckett@etfstream.com

Design and production
Pascal Don Design Ltd
T: +44 (0)7905 299 462
E: pascal.don@mac.com

Printed by
www.platinumpresslimited.co.uk
T: 0844 880 4722

Advertising and sponsorship enquiries:
info@etfstream.com

FRANKLIN LIBERTY EURO GREEN BOND UCITS ETF

GREEN BONDS: SEEKING NEW OPPORTUNITIES TO INVEST FOR GOOD

Search: franklintempleton.co.uk Ticker: FLRG

REACH FOR BETTER™

FRANKLIN TEMPLETON

The value of investments and any income received from them can go down as well as up, and you may get back less than you invested. Fund is a sub-fund of Franklin LibertyShares ICAV, an Irish collective asset-management vehicle. Issued by Franklin Templeton Investment Management Limited (FTIML), Cannon Place, 78 Cannon Street, London EC4N 6HL. FTIML is authorised and regulated by the Financial Conduct Authority. **For Professional Client Use Only. Not for Distribution to Retail Clients.**

The best performing smart beta ETFs in Q3 2020

Top performers
UK

The best performing smart beta ETFs in Q3	
Fund Name – 3 Month Total Return	**% change**
RICI Enhanced Zink TR EUR H ETC	**16.6**
Lyxor Russell 1000 Growth ETF Acc	**13.1**
iShares Digitalisation ETF USD Acc	**12.9**
iShares Edge MSCI USA Momt Fac ETF $ Acc	**12.5**
iShares Healthcare Innov ETF USD Acc	**11.6**
Xtrackers MSCI World Momentum ETF 1C	**11.2**
iShares Edge MSCI Wld Mom Fctr ETF $ Acc	**11.1**
Deka STOXX® Europe Strong Growth 20 ETF	**11.0**
Xtrackers MSCI Em Mkt ESG ETF 1C	**10.8**
iShares Automation&Robotics ETF USD Acc	**10.6**

Tesla had another admirable quarter having nearly doubled its market value and stock splitting its shares five-to-one at the end of August

Last year, we saw rhodium to be the standout performer for the year producing returns of 132.8% despite being a commodity that not many investors knew much about. However, in Q3, another commodity has taken the limelight in the form of zinc.

While much of the market was in rapid recovery mode, returns were not so extravagant this quarter as things began to level out. The Collateralized EUR Hedged RICI Enhanced Zinc Index ETC (B4N7) was the leading performer for Q3 having climbed 16.6%. Issued by BNP Paribas, B4N7 tracks a euro-hedged valuation of zinc.

There were, however, two common trends across the rest of the top performers in the form of growth and momentum equities.

The Lyxor Russell 1000 Growth UCITS ETF (RUSG) took second place returning 13.1% for the quarter while the Deka Stoxx Europe Strong Growth 20 UICTS ETF (EL4C) jumped 10.8%. Both US and European growth stocks have shown continued outperformance even after lockdown restrictions were easing across both regions.

Interestingly both ETFs have different dominant sector exposures. RUSG's largest sector exposure is consumer discretionary with 23.8% ahead of financial and consumer staples. This would suggest that public spending picked up again in the second half of the year.

EL4C, however, is significantly more tilted towards healthcare which accounts for 42.5% of the ETF. Three out of the top five largest holdings are within the healthcare or pharmaceutical companies which would make sense given the pandemic we are currently in.

Momentum factor ETFs have also offered impressive returns last quarter as markets rebounded in equally impressive timing. It took the S&P 500 five-and-a-half years to recover to the same level it was before the Global Financial Crisis in October 2007. This time around, it only took the index six months to rectify the 33% loss suffered in early-March. Of course, the circumstances of the crises differ but the damage caused to economies were equally as catastrophic. Therefore, momentum plays were a perfect opportunity for performance as the

The energy sector faced several woes for the period which meant both commodities and infrastructure equities underperformed

iShares Edge MSCI USA Momentum Factor ETF (IUMO) and the Xtrackers MSCI World Momentum UCITS ETF (XDEM) climbed 12.5% and 11.2%, respectively, for the quarter. XDEM has a 71.9% weighting allocation to the USA which is pretty dominant for a world ETF.

Tesla had another admirable quarter having nearly doubled its market value and stock splitting its shares five-to-one at the end of August. The stock accounts for 6.2% of IUMO and 3.5% of XDEM so would have been a heavy influence on those two performances.

The worst performing smart beta ETFs in Q3

Two major themes were behind the worst performing ETFs in Q3, dividends and energy. It was a tough quarter for those who rely on dividends for their income as a large portion of companies deferred their payouts this period to focus on recovering internally. In the UK alone, 445 companies listed on the London Stock Exchange either cancelled, cut or suspended dividend payments this year.

The WisdomTree UK Equity Income UCITS ETF (WUKD) and the WisdomTree Europe Equity Income UCITS ETF (EEIE) both fell 5% for the quarter.

The worst performing smart beta ETFs in Q3

Fund Name – 3 Month Total Return	% change
Lyxor S&P 500 VIX Futs EnhRoll ETF C EUR	(14.8)
L&G US Energy Infrastructure MLP ETF	(10.4)
Invesco FTSE RAFI UK 100 ETF	(8.9)
Collateralized EUR H ETC RICI En Gas Oil	(6.5)
Collateralized € H ETC RICI Enh Htg Oil	(5.9)
WisdomTree Europe Equity Income ETF	(5.0)
WisdomTree UK Equity Income ETF	(5.0)
iShares DJ Asia Pacific Sel Divi 50 (DE)	(4.5)
iShares Euro Total Mkt Val Lg ETF € Dist	(4.2)
iShares UK Dividend ETF GBP Dist	(4.1)

Secondly, the energy sector faced several woes for the period which meant both commodities and infrastructure equities underperformed. The L&G US Energy Infrastructure MLP ETF (MLPI) was the second worst performing ETF as it was down 10.4% by September's end. MLPI is comprised of US-trading companies that are involved within energy infrastructure. This includes pipeline, storage facilities and other activities associated with transporting or process of natural gases, crude oil and refined products. BNP Paribas Asset Management's euro hedged RICI enhanced gas oil ETC (BNQ1) and euro hedged RICI enhanced heating oil ETC (BNQ3) also feature on the worst performing list with returns of -6.5% and -5.9%, respectively. The two ETCs track the futures performances of gas oil, typically diesel, and heating oil, an alternative to diesel.

The reasons for the decrease in value for these two different types of oil are likely two-fold. The hesitant resumption of much of the world's travel demand in tandem with many of the largest cities in Europe implementing bans on diesel vehicles.

These factors will contribute to the falling demand in the oils and therefore will create a surplus and results in the price falling in a bid to sell off any reserves.

The worst performing smart beta product for the quarter was more as a result of the decreasing volatility in the US market. So much so, the Lyxor S&P 500 VIX Futures Enhanced Roll ETF (LVO), which tracks the VIX Futures, a measure of volatility in the US, fell 14.8%. This was definitely an interesting play for investors as the US was in the build up to the hotly-contested presidential election, however, volatility levels have been in a steady decline since its spike to 25 points mid-March. With that said, the VIX was very much at elevated levels of 15 points in Q3 compared to around 7 points in early Q1.
In the US, there are four main video games ETFs – ESPO from Van Eck, GAMR from Wedbush, HERO from Global X and this one here: NERD from RoundHill.

What is fun about this niche – its growth and novelty aside – is just how different all the video games ETFs are. They pick different stocks. They have different ways of weighting their picks and they have all delivered very different returns. NERD picks video game makers, and video game hardware companies – as is obvious. But it also picks video game tournament managers and platforms. Interestingly, NERD is mostly exposed to Asia. Most of its weighting comes from China, Japan, Singapore, Hong Kong and Taiwan. Sweden – the world's video game capital – also gets a heavy piece of the pie.

ULTUMUS
THE ETF & INDEX DATA SPECIALISTS

New smart beta listings

ESG and sustainable ETFs dominate listings

Climate change and Paris-aligned were the frequent buzzwords associated with last quarter's new ETF launches. Franklin Templeton, Deka, Amundi and Lyxor all launched equity ranges that focused on including companies that are actively engaging in reducing their carbon emissions by at least 7% year-on-year to meet the objective of the Paris agreement.

Last year, the European commission launched two benchmarks, the Paris-Aligned Benchmark (PAB) and the Climate Transition Benchmark (CTB), which are used to set the standards for these climate focused ETFs.

Franklin Templeton was the last to come to market with a range and underpriced all its competitors at 0.15%, 5-10bps cheaper than the rest of the market.

HSBC GAM sustainability push

Elsewhere, HSBC Global Asset Management (HSBC GAM) expanded its ESG ETF offering with the launch of six sustainable equity ETFs. They offer exposure to the developed world, emerging markets, Japan, Asia Pacific ex Japan, USA and Europe.

The methodology has a two-part exclusion process and a three-part tilt process. Companies are excluded on an annual basis pre-tilt if they are involved within industries such as weapons, tobacco, thermal coal etc while a post-tilt exclusion process is applied on a quarterly basis that removes companies that conflict with the UN Global Compact Principles. The tilts themselves overweight companies with greater ESG scores and carbon emission reductions while underweighting companies that have fossil fuel reserves.

Rize ETF doubles product offering

Thematic ETF specialist Rize ETF doubled its product offering with the launch of Rize Sustainable Future of Food UCITS ETF (FOOD) and Rize Education Tech and Digital Learning UCITS ETF (LERN). Following the trend of sustainability for the quarter, FOOD seeks to offer exposure to companies that will benefit from the transition to sustainable food production systems that protect the environment. This includes companies like Beyond Meat which has had shown a stellar performance since its IPO in May last year, doubling its market cap.

LERN, the first education technology ETF in Europe, seeks to capture the adoption of technology within the world's education system. This includes technologies such as adaptive learning, video content, gamification and immersion technology.

HANetf's energy and Shariah launches

European white label ETF platform HANetf has had a busy 2020 have expanded its services to launch five ETFs in the first three quarters. Two of which came in Q3 in the form of the Alerian Midstream Energy Dividend UCITS ETF (MMLP) and Almalia Sanlam Active Shariah Global Equity UCITS ETF (AMAL). MMLP is an ETF

New Listings		
Ticker	Fund name	TER
WVAL	SPDR® MSCI World Value ETF	0.25%
HSEM	HSBC Emerging Market Sustainable Eq ETF	0.18
USPA	Franklin S&P 500 Paris Aligned Clmt ETF	0.15
MMLP	Alerian Midstream Energy Dividend ETF A	0.4
HSWD	HSBC Developed World Sustainable Eq ETF	0.18
GOAT	VanEck Vectors™ Morningstar US Wide Moat UCITS ETF	0.52
FOOD	Rize Sustainable Future of Food UCITS ETF	0.45
LERN	Rize Education Tech and Digital Learning UCITS ETF	0.45
HSXD	HSBC Asia Pacific ex Japan Sustainable Equity UCITS ETF	0.25
UMDV	iShares US Medical Devices UCITS ETF	0.25
SPXPW	UBS ETF US Equity Defensive Put Write SF UCITS ETF	0.29
SPXCC	UBS ETF US Equity Defensive Covered Call SF UCITS ETF	0.29
E50PW	UBS ETF Euro Equity Defensive Put Write SF UCITS ETF	0.26
E50CC	UBS ETF Euro Equity Defensive Covered Call SF UCITS ETF	0.26
EUPA	Franklin STOXX Europe 600 Paris Aligned Climate UCITS ETF	0.15
D6RT	Deka MSCI Germany Climate Change ESG UCITS ETF	0.2
D6RS	Deka MSCI EMU Climate Change ESG UCITS ETF	0.2
D6RR	Deka MSCI Europe Climate Change ESG UCITS ETF	0.25
D6RQ	Deka MSCI USA Climate Change ESG UCITS ETF	0.25
D6RP	Deka MSCI World Climate Change ESG UCITS ETF	0.25
PABZ	Amundi Euro iSTOXX Climate Paris Aligned PAB UCITS ETF	0.18
PABE	Amundi MSCI Europe Climate Paris Aligned PAB UCITS ETF	0.18
HSWD	HSBC Developed World Sustainable Equity UCITS ETF	0.18
PABU	Lyxor S&P 500 Paris-Aligned Climate (EU PAB) UCITS ETF	0.2
GPAB	Lyxor S&P Global Developed Paris-Aligned Climate (EU PAB) UCITS ETF	0.2
EPAB	Lyxor S&P Europe Paris-Aligned Climate (EU PAB) UCITS ETF	0.2
SADM	Amundi MSCI Emerging ESG Leaders UCITS ETF	0.18
HSEP	HSBC Europe Sustainable Equities UCITS ETF	0.15
HSJP	HSBC Japan Sustainable Equities UCITS ETF	0.18
HSUS	HSBC USA Sustainable Equities UCITS ETF	0.12

Alerian Midstream Energy Dividend UCITS ETF is comprised of North American energy companies that are involved in the processing, transportation and storage of oil and natural gases

launched by US-based energy infrastructure benchmark provider Alerian. It is comprised of North American energy companies that are involved in the processing, transportation and storage of oil and natural gases, slightly against the theme of the other products launched this quarter. It synthetically replicates the index set out by Alerian and offers good exposure to those stocks which are mostly excluded from ESG ETFs.

AMAL is actively managed by Sanlam Investment Managers that selects between 20 and 35 companies that must comply with the Principles of Shariah Investment. Companies must adhere to the Shariah laws and therefore cannot be included if they have involvement within the sale of alcohol, pork, pornography, gambling or weapons. For the ETF to also be Shariah compliant, it must have appointed a Shariah board, have an annual Shariah audit and donate and interest it acquires to charity.

VanEck Vectors: Mind the moat

VanEck's European business has been relatively quiet for the last couple of years having only launched one ETF in 2019 but has now launched another ETF in 2020. The VanEck Vectors Morningstar Global Wide Moat UCITS ETF (GOGB) has a strategy that aims to pick out the most attractively priced companies that have a long-term advantage compared to their peers.

GOGB's benchmark provider, Morningstar, analyses and dictates what companies can differentiate themselves and their market shares from their competitors with the help of an economic moat rating. This rating is a company's sustainable competitive advantage which essentially scores how far ahead the company is compared to their respective peers.

SSGA's smart beta foray

Amid the recovery period mid-year alongside the continued uncertainty of geopolitical events and pandemic, State Street Global Advisors (SSGA) expanded its smart beta ETF offering with the launch of a value ETF and a minimum volatility ETF.

The SPDR MSCI World Value UCITS ETF (WVAL) tries to prove that value is not dead. MSCI selects the top 350 securities from the MSCI World by their highest combined value select score. The strategy also tries to avoid 'value traps' by incorporating both quality and value metrics. Value strategies typically perform well in recovery periods and have been put under fire recently for their underperformance during the longest bull market on record, however, recent crisis could be value's time to shine.

Two weeks before the launch of MVAL, SSGA launched SPDR STOXX Global Low Volatility UCITS ETF (GLOW). Its index picks the 200 least volatile stocks from the STOXX Global 1800 index. It allows stocks with more than 2.5% weighting in the parent index to deviate up to 5% in GLOW while stocks with less than 2.5% weighting are limited to three times their weight in the parent index.

RETURN TO CONTENTS

ESG and gold: A justified allocation or simply greenwashing?

ETF Stream's deputy editor Tom Eckett argues why incorporating gold in ESG portfolios is crossing the line of what can be deemed sustainable

Tom Eckett joined ETF Stream as a senior writer in March 2019 before being appointed deputy editor in January. He started his career at Investment Week in August 2016 as an asset management correspondent covering ETFs.

The rise of environmental, social and governance (ESG) investing has been nothing short of remarkable and is even starting to enter areas not thought possible a decade ago. One such area is gold. The benefits of incorporating gold in a multi-asset portfolio are well documented. Over the past four decades, as the price has become more stable, the precious metal has been used as an effective hedge against black swan events.

As a result, assets in gold ETCs have skyrocketed this year with more buyers looking to diversify their risk due to the rapid spread of coronavirus across the globe, however, some of these inflows have come from an unlikely source, ESG investors. The rationale is simple. With bonds no longer acting as the safe haven of the past due to increasing correlations to equities and debt negative yielding, multi-asset investors have had to find other ways to improve the risk-return profiles of their funds. One obvious solution, especially in the ETF space where there is a distinct lack of alternative strategies, is gold.

One such wealth manager that has made the move into gold is UK disruptor Nutmeg. The firm's balanced ESG model portfolio, for example, has a 2.2% weighting to the Invesco Physical Gold ETC (SGLD). In order to avoid calls of greenwashing, the wealth manager has written extensively on the reasons why including gold in an ESG portfolio is justified. Rumi Mahmood, head of ETF research at Nutmeg, told ETF Stream the regulatory developments in the space and the access to conflict-free, responsibly sourced gold has enabled multi-asset investors to make this allocation without the concerns of having a negative ESG impact.

Where Mahmood and other industry participants are quick to point to is the London Bullion Market Association's (LBMA) Responsible Sourcing programme which came into effect in 2012. The programme requires refiners to engage with producers in defining minimum requirements that are mandatory along the entire precious metal supply chain. It ensures gold is responsibly sourced and free from any conflict. Hector McNeil, co-founder and co-CEO of HANetf, whose white-label platform helped launch The Royal Mint Physical Gold ETC (RMAU) last year, argued ETCs which are 100% backed by gold bars that meet the LBMA's standards gives them an ESG stamp of approval.

RESPONSIBLE SOURCING

As a HANetf report said: "Investors who enjoy the diversification benefits of holding gold in their portfolio have long demanded the gold industry to make the necessary strides to provide clarity around the provenance of gold that goes into making the gold bars. The industry met the challenge by implementing a policy around responsibly sourced gold."

A key point that HANetf and other ETF issuers with newer gold strategies stress is pre-2012 gold cannot be relied upon to be conflict free as this was before the LBMA introduced its standards. "Investors are assured that the gold is extracted in a manner that does not cause, support or benefit unlawful armed conflict or contribute to serious human rights abuses or breaches of humanitarian law. In contrast, older gold ETFs and ETCs are more likely to hold physical gold that was not responsibly sourced. The older the ETC being held, the more likely it will have bars that do not meet the programme's strict requirements and their creation and redemption processes do not specify this subset of LBMA 'good delivery' bars."

However, simply because the newer gold ETCs are 'greener' and will have higher ESG ratings, does not mean they should be meeting the standards of

ESG investors. While the LBMA's programme has a big focus on ethical sourcing, it does little to address the environmental impact of gold bar production. This is as much admitted by Nutmeg's Mahmood who argued the framework is developing and the next iteration of the guidance is expected to relate to the environment. He added that gold has among the lowest greenhouse gas (GHG) emissions per dollar out of the major mined products and its carbon footprint is low as well.

ENVIRONMENTAL FACTORS

However, Andrew Limberis, senior associate at Omba Advisory & Investments, was not so forgiving with the view that investments in gold can be sustainable. From a social and governance perspective, the LBMA's programme goes some way in meeting ESG criteria, however where the precious metal falls down is on environmental factors.

"From an environmental standpoint, there can be no debate on the high cost to the environment, not least due to the high water usage in mining," Limberis continued. "Any improvement in environmental mining practice is great but improvement does not equal ESG.

"The other factor that works against gold being considered ESG is its fungibility and history. While some gold ETCs avoid gold that was refined pre-2012, the gold market is still largely fungible (at least in price). Is owning a gold bar mined and refined in 2018 better than one from 2000 when they both trade at the same price? I am not so sure. That is not to say that gold (and commodity markets in general) can never rid themselves of their past challenges from an ESG perspective, but the transparency and expectations around responsibly sourcing gold should be significantly improved."

Meanwhile, Peter Sleep, senior investment manager at 7IM, pointed to the energy intensive nature of gold product. He said the average cost of producing a gram of gold for the industry is around $1000 per Troy ounce which is approximately the figure for the biggest gold produce Barrick. While there are 31g in a Troy ounce meaning you have to dig up around 15 tonnes of rock which has to be crushed and treated with sulphuric acid to extract the gold.

"The waste is a chemical soup of heavy metals which is put into tailings ponds to evaporate," Sleep continued. "If we are lucky the tailings dams do not break and pollute the local water supply as happened in say Brazil. Producing gold is a dirty business for something that is essentially a luxury product."

While the LBMA's programme is certainly a huge positive for the industry, to say gold ETCs that are exposed entirely to responsibly sourced bars is not enough for it to be labelled ESG. The environmental issues that are still at play do not make gold a true ESG investment and therefore investments in this area can certainly be seen as more greenwashing in a move to improve a portfolio's risk-return profile rather than justified from an ESG perspective.

From an environmental standpoint, there can be no debate on the high cost to the environment, not least due to the high water usage in mining. Any improvement in environmental mining practice is great but improvement does not equal ESG

RETURN TO CONTENTS

Factor investing drivers in a post-quantitative easing world

Financial Times columnist David Stevenson examines how the factor investment landscape will look in a post-quantitative easing (PQE) world

The news that Pfizer seems to have an efficient and workable vaccine for COVID-19 prompted a remarkable market rally. Yet much the most interesting aspect of this bounce back was that many tech-based growth stocks significantly underperformed while more traditional value stocks, especially those with a strong cyclical bias shot up disproportionately in value.

Quant analysts have been banging the drum about value underperformance for years now, warning that when the reversal came, the 'turn' would be brutal. And so, it was, with some stocks advancing by more than 25% in just one days trading. So, contra we value cynics, maybe value investing is not dead after all although the time compression of this bounce back was so brutal that if you had have been stuck in that cave with a poor mobile signal you would have probably missed the value revival.

But COVID-19 aside, there is need for a more fundamental reckoning. My hunch is COVID-19 has not really changed anything for investment fundamentals and especially not factor analysis, yet COVID-19 has reminded us that central bankers have become the new frontline for macroeconomic policy. Sure, there has been fiscal rebalancing, which was much needed, but who can honestly believe that come the next economic downturn, central bankers will not be raiding the armoury for new monetary weapons and tools – top of the list will be e-money and direct money transfers. My point in emphasising the role of central bankers is that they are here to stay, and their influence will not be diminishing any time soon.

My hunch is COVID-19 has not really changed anything for investment fundamentals and especially not factor analysis, yet COVID-19 has reminded us that central bankers have become the new frontline for macroeconomic policy

Which brings us nicely to why this might have an impact on investment styles and factors. Put bluntly quant investors need to accept that the old textbooks written before QE (BQE) need rewriting in an age of experimental monetary (and fiscal) policy – post QE or PQE. This binary distinction between BQE and PQE is crucial to understanding how loose monetary policy has introduced strong drivers that in turn affect factor-based outcomes. In simple terms, PQE policies have hugely skewed factor-based results.

I would suggest there are two transmission mechanisms at work which shape this skew towards some factor premia. The first is ably outlined in a recent paper by US equity analysts at French investment bank Société Générale (SocGen). They have crunched the numbers on how the Federal Reserves has skewed key benchmark indices. The key driver here has been changes to the discount rate, based around an internal equity risk premium framework.

This drives through to changes in the US Treasury 10-year bond yields which, when added to other variables such as total Fed assets, leads to the following conclusion: "Since 2009, the cumulative impact of the different waves of GE on US Treasury 10 year bond yields were approximately 180 basis points. Without QE, US Treasuries would have been around 2.8%."

How has that impacted equity markets in the US? The SocGen team reckon the most impacted index has been the Nasdaq and the least impacted are US small caps in the S&P 600. "As of October 2020, the Nasdaq price level was 57% explained by QE. In fact, without QE, the NASDAQ 100 should be closer to 5,000 than 11,000 while the S&P 500 should be closer to 1,800 rather than 3,300."

A common sense narrative backs up this analysis. Large caps have disproportionately benefitted from

low interest rates plus they boast low payout ratios and higher book to price numbers while growth stocks have spent large amounts of cash on buy backs. According to the SocGen analysts, "small and mid-caps, on a relative basis, given their higher payout and lower price to book value ratios, are less sensitive to bond yields".

Again, in simple terms, QE benefits growth stocks and quality stocks, but all bundled up within a framework that favours mega large cap stocks overall. By contrast small caps have less access to the bond markets, have weaker balance sheets and can spend less money on dividends and buy backs. Therefore, PQE the traditional small cap premia starts to fade away.

WIDENING INCOME INEQUALITIES

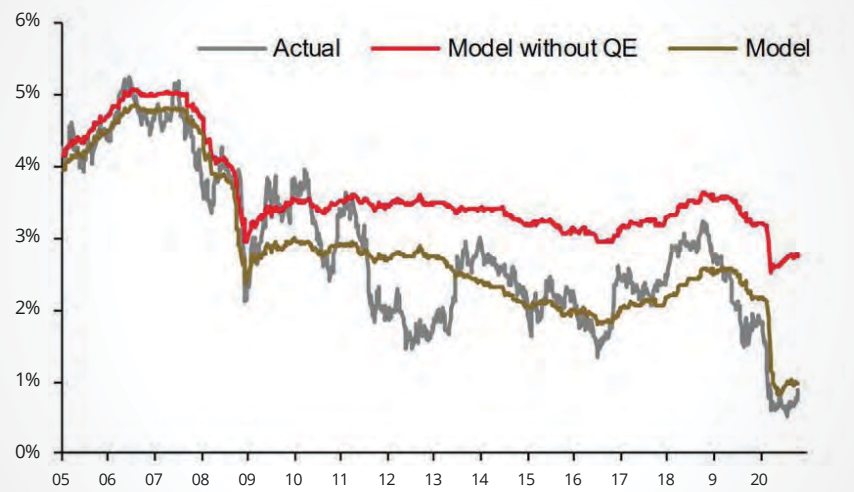
I would also hazard to add a second transmission – the distribution of wealth. For the record, I am no socialist and I have a fairly relaxed view about wealth and income inequalities (to a point) but even I would hazard the observation that PQE we have seen an increase in inequality as wealthier, equity investors (and they tend to be much wealthier, older and male) have disproportionately benefitted from QE. If one accepts this analysis – and its hard to disagree with the hard numbers behind this conclusion – then we also need to peer into the behavioural mindset of these wealthy investors and their advisers.

I would hazard three crucial drivers of behaviour which in turn might impact different factor premia. The first is wealthier investors can, by and large, afford to take more risks. Therefore, they are more willing to invest in less liquid stuff (private equity for instance) or higher rated stocks (tech and growth stocks) because they can afford the downside risk.

Wealthier investors are likely to have elongated life expectancies which means they can afford to take a longer time horizon for their investments, thus increasing their appetite for risk. In addition, wealthier investors also tend, in my experience, to hold a large share of what I call primary, personal assets such as housing wealth. These assets have disproportionately benefitted from PQE which in turn allows these older, wealthier investors to take more risk with the (smaller) proportion of wealth invested in risky assets.

Another driver might also be a bias against dividend-oriented value stocks. Most market commentators have tended to assume that PQE policies have pushed investors towards a scramble for yield, which should benefit higher yielding stocks. But I would wager that the opposite has in fact played out. Wealthier investors have less need of a large, sustained income from their risk assets. If they seek a pre-determined income outcome they are more likely to a) seek out alternative assets such as infrastructure with defined income terms or b) in effect draw down income by liquidating capital gains and thus avoiding a tax liability. Therefore, these investors are more likely to be interested in preserving and growing their wealth rather than prioritising income at all costs.

CUMULATIVE IMPACT OF FED QE ON UST 10Y: 180BP SINCE 2009



Indicators used: Fed balance sheet, Fed funds rate, US 10y breakevens, Conference Board US Leading Indicator.
Source: Bloomberg, SG Cross Asset Research/Equity Strategy

Add these drivers up and we can begin to discern a possible, putative transmission mechanism at work driven by PQE policies. Wealthier investors – older, male and upper middle class – will be more inclined to chase momentum flows because they can afford to take extra risk. They will also seek out quality stocks rather than classic dividend focused value stocks. Lastly, because they have a longer investment time horizon, and a greater willingness to take risk, they will also be more willing to embrace growth-based strategies. The subset of older investors who are more risk oriented, and income hungry might by contrast find themselves gravitating towards low vol strategies and quality.

This second transmission mechanism PQE based around inequality is more speculative but does offer some possible narratives which explain how factor premia outcomes might have been skewed by central bank monetary innovation. I would add one caveat though – none of the above would mean that any particular risk premia will vanish PQE. As the value bounce in recent weeks amply demonstrates, if investors can make more returns by betting on cyclical, post-COVID-19 bouncebacks, they will willingly embrace that risk.

David Stevenson trained as a economist before moving into financial journalism where he has written about investing and finance for many years. David is CEO and Editor in Chief of AltFiNews and is also a columnist for the Financial Times (the Adventurous Investor), Investment Week and Money Week. David is an experienced media entrepreneur (he's set up a number of online media companies focused on online TV and viral videos) and investment expert of retail repute.

RETURN TO CONTENTS

Quality investing: An all-weather approach

Is it worth paying for quality? Pierre Debru, director, research at WisdomTree, explains why the quality factor is effective in both rising and falling markets

Warren Buffett's widely-read annual letters to shareholders offer a fascinating insight into Buffett's investment philosophy. After analysing his letters, we believe one key phrase is "businesses earning good return on equity while employing little or no debt"[1].

However, Warren Buffet does not stand alone in his focus on high quality stocks. quality Investing has a long history behind it and other practitioners like, his mentor, Benjamin Graham or Jeremy Grantham from Grantham, Mayo, & van Otterloo (GMO) are also well-known proponents. In academia, Fama and French introduced the "quality premium", using operating profitability as main metric[2].

AN ALL-WEATHER APPROACH

Academics have demonstrated that equity factors have the capacity to outperform the market over long periods of time. However, they have also shown that those equity factors are very different and tend to behave very differently. So why focus on quality?

In the following, we look at seven different equity factors in global equities. Over the full period considered (1999 to September 2020,

FIGURE 1: CALENDAR PERFORMANCE OF EQUITY FACTORS[3]

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	YTD
1st	Min Vol -30%	Size 44%	Size 26%	Min Vol 7%	Size 18%	Size 32%	Min Vol 11%	Min Vol 5%	Size 13%	Mom 32%	Min Vol -2%	Qual 36%	Growth 19%
2nd	Qual -34%	Value 41%	Mom 16%	Mom 4%	Growth 16%	Value 32%	Qual 8%	Mom 4%	High Div 9%	Growth 28%	Mom -3%	Growth 34%	% Mom 16%
3rd	Mom -40%	Growth 33%	Growth 15%	High Div 4%	Market 16%	Mom 30%	Mom 7%	Qual 4%	Value 8%	Qual 26%	Qual -6%	Mom 28%	Qual 11%
4th	Market -41%	Qual 33%	Min Vol 12%	Qual 4%	Value 14%	Qual 27%	Growth 6%	Growth 3%	Market 8%	Size 23%	Growth -7%	Market 28%	Market 2%
5th	Growth -41%	High Div 32%	Market 12%	Growth -5%	Mom 14%	Growth 27%	Market 5%	Size 0%	Min Vol 7%	Market 22%	High Div -8%	Size 26%	Min Vol -3%
6th	Size -42%	Market 30%	Qual 11%	Market -6%	Qual 13%	Market 27%	Value 4%	Market -1%	Qual 5%	Value 22%	Market -9%	Min Vol 23%	Size -6%
7th	High Div -43%	Min Vol 16%	Value 9%	Size -9%	High Div 12%	High Div 22%	High Div 2%	High Div -3%	Mom 4%	High Div 18%	Size -14%	High Div 23%	High Div -10%
8th	Value -43%	Mom 14%	High Div 6%	Value -12%	Min Vol 8%	Min Vol 19%	Size 2%	Value -3%	Growth 3%	Min Vol 17%	Value -14%	Value 19%	Value -19%

Source: WisdomTree, Bloomberg. December 1998 to 30 September 2020. MinVol stands for MSCI World Min Volatility net TR Index. Qual stands for MSCI World Quality net TR Index. Mom stands for MSCI World Momentum net TR Index. Market stands for MSCI World net TR Index. Growth stands for MSCI World Growth net TR Index. Size stands for MSCI World Small Cap net TR Index. HighDiv stands for MSCI World High Dividend net TR Index. Value stands for MSCI World Enhanced Value Dividend net TR Index. Historical performance is not an indication of future performance and any investments may go down in value.

in Figure 1 we show only the last 13 years) they all have outperformed the MSCI World index. However, Figure 1 shows that every year a different one won and a different one lost and they all exhibited a different behavior:

- Min volatility has historically been very strong in equity down years, but very poor in stronger equity years. It outperformed in 11 out of the 22 years but was top two or bottom two, in 14, showing large outperformance or large underperformance.
- Size behaved in an almost opposite way as min vol (If min vol is 'defence', size would be 'offense'). It outperformed in 14 years but was top two or bottom two in 14 as well.
- Quality outperformance over the benchmark has been more consistent. It outperformed the benchmark in 14 years also, but it ended up in the top two or bottom two only eight times. In most years, it delivered a controlled outperformance which means that it could have been used strategically with limited risk of a significant underperforming year.

In other words, quality stocks benefit from strong business models and steady financial results over time. When building investment strategies focused on quality stocks, this historically translated into steady, robust returns in many market scenarios.

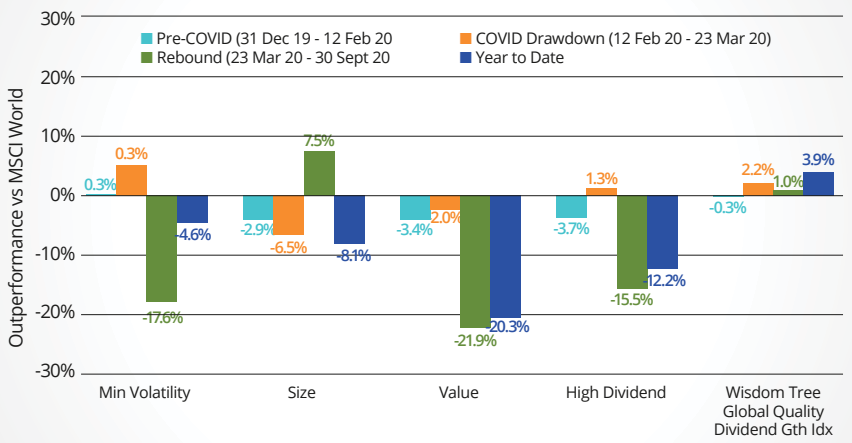
WISDOMTREE'S APPROACH

Turning to our approach to quality investing, we focus on profitability with companies with high return on equity and low debt. Our Quality Dividend Growth approach invests in a diversified basket of highly profitable, environmental, social, and corporate governance ("ESG") compliant companies.

The following general principles are used in creating our Quality Dividend Growth indices:

- Companies must meet our ESG Guidelines[4] (companies which are breaching UN Global Compact principles or are involved in controversial weapons, tobacco or thermal coal are excluded).
- Companies must have dividend coverage ratios greater than 1.0x.
- Companies must meet our risk management framework[4] that excludes low momentum and low-quality stocks as well as potential value traps.
- The Indices comprise of companies with the best combined rank of quality and growth factors from this universe:
  - Quality is based on return on assets (ROA) and return on equity (ROE).
  - Growth is based on analysts' long-term earnings growth expectations over the company's next full business cycle.

FIGURE 2: PERFORMANCE OF EQUITY FACTORS IN 2020[3]



Source: WisdomTree, Bloomberg. Period December 2019 to 30 September 2020. Historical performance is not an indication of future performance and any investments may go down in value

- Weighting: The Indices are rebalanced annually according to the "dividend stream" i.e. weighted to reflect the proportionate share of the aggregate cash dividends bringing valuation discipline to the strategies.

MANAGING AN EVENTFUL 2020

Looking back at the past 9 months, equity markets had to cope with the fastest drawdown in history followed by one of the fastest rebound. In such a difficult environment, equity factors did not all pass the test with flying colors.

- Min volatility was the best factor in the drawdown itself (+5.2% versus the market). However, its sluggish rebound left it trailing the market by 4.6% after nine months.
- Size did the best in the rebound, but it suffered so much in early 2020 that it is still trailing the market by 8.1%.
- Income oriented strategies endured a very difficult year. Some did well in the drawdown, some did not but all struggled early in the year and in the current rebound. Overall, they trail the markets by double digit numbers.
- Looking at the WisdomTree Global Quality Dividend Growth strategy, it did not "win" any of the sub periods, but by its sheer consistency, it is showing an outperformance of 3.9% versus the market year to date. It beat the market both in the drawdown as well as in the rebound.

[1] Buffett, Warren. 27 February 2015.
[2] Fama, Eugene F. & Kenneth R. French. *"A Five-Factor Asset Pricing Model"*
[3] Equity Factors are proxied by the relevant MSCI World net TR indices.
[4] From 22 October 2020

RETURN TO CONTENTS

ESG and SRI factor sensitivities to the business cycle

Are ESG ETFs made equal? Steven Goldin, managing partner and co-CIO at Parala Capital, compares ESG ETFs offering exposure to the same market to see how they perform over the business cycle

In this article we take a look at some of the largest passive US and global ESG and SRI ETFs with one or two additional ones included for variety. Although ESG investments tend to capture, or in the case of index linked ETFs be biased towards, a set of criteria that measure desireable corporate practices, and SRI is more about reflecting very specific investor social values in their construction, when it comes to indices and ETFs that track them there is a lot of nuance and variety.

Additionally, there are many ETFs that appear to be tracking the same index but on closer inspection there appear to be many customisations applied to the index providers flagship versions including (1) extended constituent universes, (2) fossil fuels criteria, (3) 'leaders', 'focus', 'select' tweaked versions and (4) extra diversification rules.

CHOOSING WHAT TO ANALYSE

US and global are two of the largest ESG and SRI categories. BlackRock is the largest issuer with State Street Global Advisros, DWS, Vanguard, Amundi and UBS all represented in the top 25 ranked by assets. MSCI appears to be the index provider of choice. S&P Dow Jones Indices has reasonable traction with variations on the S&P 500 and FTSE Russell indices have traction with their 'Choice' family with Vanguard. We will use indices for the analysis because they tend to have longer track records than the ETF products. Unfortunately, FTSE Russell's index history is too short for inclusion so

we have added an ESG index by STOXX into the analysis despite a low level of ETF assets tracking. The following indices are included in the analysis representing a big cross section of tracked assets:

US ESG and SRI Indices

- MSCI USA Extended ESG Focus
- MSCI USA SRI
- S&P 500 ESG
- S&P 500 Fossil Fuel Free

Reference Market Benchmarks

- MSCI USA
- S&P 500

Global ESG and SRI Indices

- MSCI World ESG Screened
- MSCI World SRI Select Reduced Fossil Fuel
- STOXX Global ESG Leaders

Reference Market Benchmark

- MSCI World

Since the ESG and SRI indices have a high correlation with market beta benchmarks, the analyses is primarily focused on their differences relative to market benchmarks.

THE BUSINESS CYCLE AND ITS INFLUENCE ON ASSET PRICES

The business cycle moves through stages in which it expands, contracts and recovers and these stages have an influence on asset prices. During the early stage of a recovery, stocks and commodity prices tend to rise and during a contraction stock prices tend to weaken while bond prices strengthen.

The returns of equity sectors are also sensitive to the business cycle. Industrials and financials, for example, tend to strengthen during the early stages of a recovery while technology stocks begin to shine as the business cycle moves into expansion.

Finally, the business cycle has demonstrably impacted risk premia for factors such as size, value, momentum and quality. For example, value stocks have tend to do particularly well in periods of recovery and less well during contractions. These relationships, of course, do not always hold and vary across markets.

This article specifically looks at US and global ESG and SRI risk premia sensitivities to macroeconomic variables and the business cycle while comparing and constrasting some of the main indices tracked by the largest ESG and SRI ETFs.

TRACKING ERROR OVER ROLLING THREE YEAR PERIODS

SRI indices appear to have larger tracking error to their reference market benchmark than ESG indices

CHART 1: TRACKING ERROR OVER ROLLING THREE YEAR PERIODS

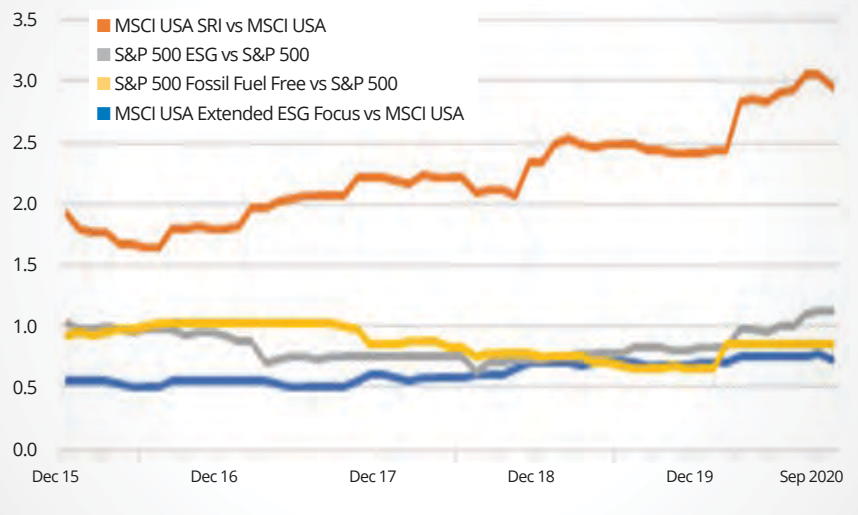
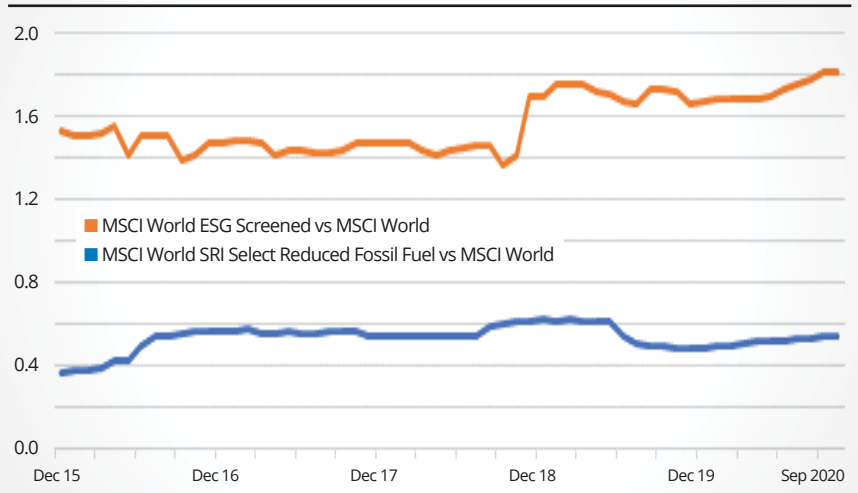


CHART 2: TRACKING ERROR OVER ROLLING THREE YEAR PERIODS



(see Table 1). Notice how MSCI USA SRI has the largest tracking error in the chart below and it has been increasing recently. The same holds true for global SRI indices compared to ESG indices where we can see that MSCI World SRI Select Reduced Fossil Fuel has an unambigulously higher tracking error to the MSCI World. This is relatively intuitive as ESG tends to focus on ESG criteria from an investment value perspective while SRI is about ensuring the portfolio represents the values of the investor which may imply a greater number of sector and stock exclusions (see Table 2).

A LOOK ACROSS US ESG AND SRI FACTORS

The table below shows the latest business cycle sensitivities for the selected US ESG and SRI indices as at 31 October. The values can be thought of as the macroeconomic betas for these indices where

CHART 3: US ESG AND SRI FACTORS

	Default Spread	Term Spread	Short Rate	Inflation	Dividend Yield	Leading Economic Indicator
MSCI USA Extended ESG Focus	-0.19	-0.04	-0.08	0.04	0.30	0.00
MSCI USA SRI	-0.44	-0.44	-0.23	0.21	0.30	-0.07
S&P 500 ESG	-0.18	-0.22	-0.12	0.05	0.51	-0.02
S&P 500 Fossil Fuel Free	-0.07	-0.10	0.04	-0.04	-0.41	0.01

CHART 4: GLOBAL ESG AND SRI FACTORS

	Default Spread	Term Spread	Short Rate	Inflation	Dividend Yield	Leading Economic Indicator
MSCI World ESG Screened	0.07	-0.09	-0.10	0.01	-0.25	0.02
MSCI World SRI Select Reduced Fossil Fuel	-0.17	-0.09	-0.19	0.08	0.37	-0.06
STOXX Global ESG Leaders	-0.73	0.56	0.71	-0.12	-1.06	-0.17

CHART 5: YEAR-TO-DATE PERFORMANCE

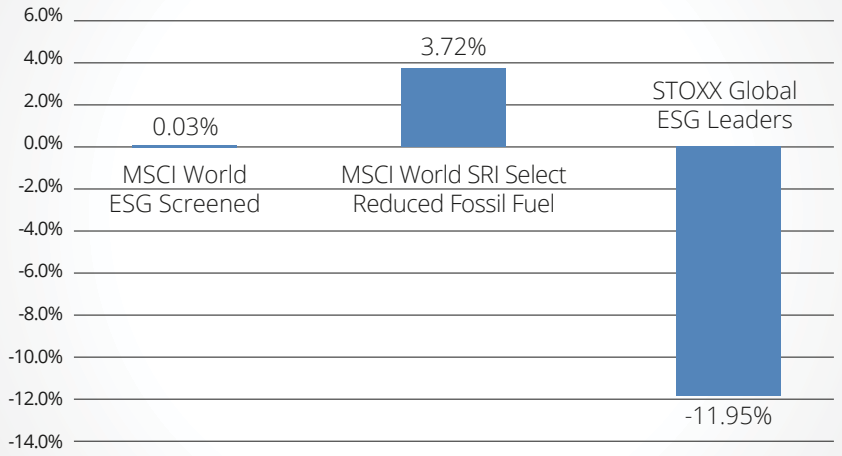


CHART 6: SENSITIVITY OF MSCI USA EXTENDED ESG FOCUS AND S&P 500 ESG

we focus on their residual returns after accounting for market, size, value and momentum factors exposures. The most meaningful comparison is for each business cycle variable column.

Table 3 shows that the US ESG and SRI indices have different business cycle sensitivities and are a useful guide for how they may perform across different macroeconomic environments. As an example, if the default spread were to widen due to a credit crisis or general deterioration in economic conditions then MSCI USA SRI may perform worst (all else being equal) because it has the largest negative sensitivity to the default spread.

On the other hand, the S&P 500 Fossil Fuel Free has the least negative sensitivity to default spread sensitivity and may perform better than other US ESG and SRI indices. As another example, we are currently seeing the term spread widen. If this trend were to continue, MSCI USA Extended ESG focus is best positioned (all else being equal) because it has the lowest negative sensitivity to the term spread.

Lastly, if we experience an increasing dividend yield then the S&P 500 ESG may be expected to perform better than S&P 500 Fossil Fuel Free because the former has a positive sensitivity to the dividend yield whereas the latter has a negative sensitivity.

A LOOK ACROSS GLOBAL ESG AND SRI FACTORS

Continuing the same analysis, the table below shows the latest business cycle sensitivities for the selected global ESG and SRI indices as at 31 October 2020. The STOXX Global ESG Leaders index has

the largest sensitivities across the macroeconomic variables because the index has a larger tracking error to the reference market index, which means its residual returns are larger.

You can see that MSCI World ESG Screened and MSCI World SRI Select Reduced Fossil Fuel often have sensitivities opposite of each other which indicates they are likely to behavior somewhat differently across the business cycle. MSCI World SRI Select Reduced Fossil Fuel has the largest negative sensitivity to the short rate followed by MSCI World ESG Screened while STOXX Global ESG Leaders has a strong positive sensitivity to the short rate.

All else being equal, during periods of falling interest rates like we have experienced this year, MSCI World SRI Select Reduced Fossil Fuel may be expected to deliver the best performance among these indices and the STOXX Global ESG Leaders the lowest performance. This was indeed the case and is shown in the Table 4.

YEAR-TO-DATE PERFORMANCE

Different macroeconomic sensitivities may lead to different investment performance (see Table 5).

Active and passive investments have different sensitivities to the business cycle and these sensitivities change over time. Additionally, the same factors constructed by different providers may impact investment behavior across the business cycle and it is useful to have a framework (or system) to evaluate factor exposures and macroeconomic sensitivities of prospective investments and potential portfolio combinations of various investments. Below we show two US ESG indices, which are tracked by several large ETFs, and their changing sensitivities to the default spread

CHANGING SENSITIVITY OF MSCI USA EXTENDED ESG FOCUS AND S&P 500 ESG TO THE DEFAULT SPREAD

Table 6 shows how the sensitivity of these two indices to the default spread has changed over time. During the earlier part of 2016, we can see that MSCI USA Extended ESG Focus had a positive sensitivity to the default spread which continued to February 2020 whereas S&P 500 ESG had a negative sensitivity until November 2018 before turning positive.

Notice how both indices sensitivity to the default spread turns negative in April 2020 around the time of the economic shock caused by the pandemic and lockdown. It is around this point that the Fed stepped in to provide stimulus, lowering interest rates as well as providing credit and acting as a buyer of last resort which put a cap on the spike in credit spreads. Both indices have a negative sensitivity to the default spread as at October this year.

Steven Goldin is the managing partner at Parala Capital, a London-based quantitative investment advisory firm with over $2 billion in assets under advisement. Earlier in his career, he worked at S&P Global, acting as their global head of strategy indices, and at Prudential, as the head of quantitative analytics.

RETURN TO CONTENTS

The 'myths' around indexing and ESG

BlackRock's James Gloak discusses the drivers behind sustainable strategies and the appropriate methods available to investors

iShares by BlackRock

For professional clients and qualified investors only

The EMEA Sustainable ETF market has soared over the past two years as assets enter the market in tandem with the launch of new and innovative products. This year, Sustainable ETF assets in Europe have doubled to $67bn (end of October), highlighting the strong growth that has taken place in the space.

This year, in particular, has been a monumental year for sustainable ETFs following significant outperformance of their parent products which has offered some downside protection during the volatile periods experienced at the end of Q1.

While some market participants point to 2020 as the breakout year for ESG, James Gloak, iShares sustainable investing specialist at BlackRock, believes this momentum began back in 2018.

Discussing the drivers behind sustainable strategies and the appropriate methods available to investors, here is what Gloak had to say.

WHAT HAVE BEEN THE MAIN REASONS BEHIND THIS INCREASE IN INVESTOR DEMAND AND DO YOU EXPECT IT TO CONTINUE?

While the inflows have been significantly large in 2020, this is not unique to this year. Last year was record-breaking for EMEA Sustainable ETFs and this surge actually began towards the end of 2018.

To put it into perspective, the EMEA sustainable ETF industry gathered $5bn in assets for 2018 which then jumped to $18.5bn for 2019. To the end of October this year, EMEA has raised $32bn in sustainable ETF assets, already overtaking last year's flows total even with coronavirus 'handbrake'. While it looks like we will not be more than tripling assets again this year, this will likely be seen as an extension of last year's breakthrough.

What has happened in 2020 is that ESG has been brought to the attention of an even wider audience. This was down to multiple publications covering the outperformance of ESG indexes vs their parent, as well as the resilience of ESG ETF flows, during the mid-February to mid-March market downturn[1].[1] Investors that are starting to look at sustainable strategies, will no doubt have seen this increased 'noise' and positive market data, and this could well have brought forward their move into sustainable by six to nine months.

At BlackRock, this has been reinforced by the increase seen in requests for information on our sustainable strategies, and, as more ESG data on companies comes to light, either voluntarily or through regulatory direction, we see sustainable strategies becoming more appealing and supporting the move towards 'sustainable being the new standard'.

WHY SHOULD INVESTORS CONSIDER AN INDEXING APPROACH WHEN IT COMES TO INVESTING SUSTAINABLY?

Sustainable investing used to cater to niche investors and was often considered expensive, values-focused and indifferent to performance. Indexation is helping to upend these perceptions by delivering choice, value and access to all investors.

The growing recognition that sustainability can influence risk and return has contributed to the recent growth of sustainable indexing, both in ETFs and mutual funds.

There is currently a change underway where more and increasingly standardized ESG data will help support the growth of sustainable indexing. More and better standardized ESG data can have two key positive impacts: driving better ESG indexes and

"Sustainable indexing has brought significantly greater choice to the market, both across equities and bonds, thereby making it possible to create an entire portfolio out of sustainable funds"

improving measurability for companies to change their sustainable behaviours.

Through indexing investors can access ESG at a fraction of the cost compared to active funds. Until recently, sustainable investment strategies were available only through higher-fee actively managed funds or highly customised mandates that required in-house ESG specialisation. Sustainable indexes are helping drive down the total costs of investing sustainably, while broadening the variety of available exposures. An example of iShares removing the price barrier to sustainability is that our ESG Screened and ESG Enhanced ETF exposures are priced the same as their standard ETF counterparts[2].

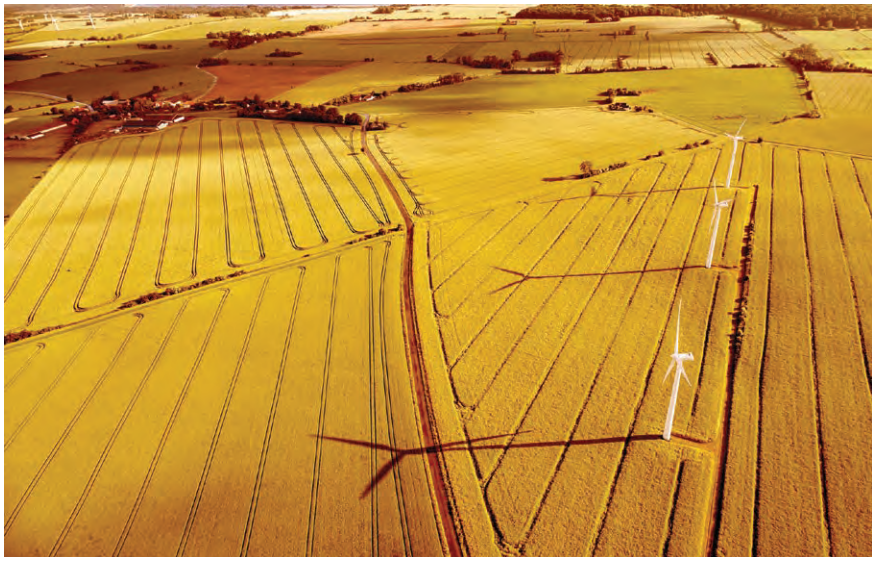
And finally, sustainable indexing has brought significantly greater choice to the market, both across equities and bonds, thereby making it possible to create an entire portfolio out of sustainable funds. At the same time, the methodologies that guide sustainable ETFs and index funds are inherently transparent, which helps investors build portfolios with consistent sustainable outcomes. They also make it possible for investors to clearly articulate their objectives to stakeholders.

WHAT SOLUTIONS DOES iSHARES OFFER IN THIS SPACE?

At BlackRock, we've looked to provide a range of product offerings across the 'sustainable spectrum' to meet the investment needs of clients wherever they are on their sustainable journey. We therefore have three main ESG strategies: a simple exclusionary only offering, an ESG optimised strategy and an ESG 'top performers' strategy.

The ESG top performers strategy, our SRI range, is our flagship sustainable offering having launched in 2016 and currently makes up $16bn out of a total of $25bn in iShares EMEA sustainable ETF assets. Our exclusionary strategy (ESG Screened) and ESG optimised strategy (ESG Enhanced) were both born out of a client consultation we held back in 2018. The majority of clients voiced their need for a simple exclusionary only strategy (ESG Screened launched Oct'18) which removed business activities such as tobacco production, controversial weapons and thermal coal. However, there was also demand for these screens with an ESG improvement plus tracking error target and this became our ESG Enhanced range in March 2019. These ranges are now $4.6bn and $1.7bn in AUM respectively.

In each of these ranges we have launched multiple exposures (World, EM, Europe, EMU, USA, Japan) in order to provide the underlying building blocks that a client might need to transition from a standard portfolio to a sustainable one.



Combined with the choice of offerings we provide across the sustainable spectrum, we believe we have an ESG strategy that a client can feel comfortable and confident in transitioning to wherever they are on their sustainable journey. They can either stay close to the standard index in terms of risk and performance whilst implementing exclusions or exclusion with ESG improvement, or progress further along the spectrum and only select those companies with the highest ESG performance. This can also be used as a 'stepping stone' approach allowing clients the flexibility to move along the spectrum as their investment and sustainable needs dictate.

Whilst the AUMs of our ESG Screened and ESG Enhanced strategies might still be relatively small compared to that of our longer established SRI strategy, we see significant potential for growth as these two strategies are very much being seen and used as the 'ESG alternatives' to standard offerings and so are well positioned to support investors taking their first steps in sustainable.

[1] BlackRock with Q1 2020 data from Bloomberg and Morningstar as of 7 May 2020. Over 90% of sustainable indices outperformed their parent benchmark during this period of the heightened market uncertainty and drawdown. **Past performance is not a reliable indicator of future performance**.

[2] BlackRock as of November 10, 2020

Capital at Risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested. BlackRock has not considered the suitability of any investment against your individual needs and risk tolerance. All figures are from BlackRock as of November 10, 2020.

James Gloak, Vice President, is a sustainable investing strategist for iShares in EMEA, responsible for helping grow ESG strategies, develop client sustainable understanding and help craft sustainable narratives and thought leadership. Prior to joining BlackRock, James served in the military for over a decade.

RETURN TO CONTENTS

Is it possible to achieve positive impact through ETFs?

A bridge too far for ETFs? Anna Fedorova investigates the claims investors can only have a positive sustainable impact through active management

Anna Fedorova is a freelance financial journalist, copywriter and editor with nearly a decade of experience, specialising in investment and sustainable finance. Before going freelance, she spent most of her career with Investment Week, latterly as news editor. Since then she has written for a wide range of titles, including Morningstar, What Investment and ESG Clarity.

Assets in ESG ETFs have ballooned this year as demand for low-cost ways to invest sustainably grows, but opinions differ on whether it is possible to achieve real positive impact via passives. Yet even as opponents argue impact investing is the realm of active managers, ETF issuers are working on products to rival active propositions.

Impact investing is the most rigorous approach to ESG which aims to generate a measurable beneficial social or environmental impact alongside a financial return. A key part of achieving this is engagement with investee companies and passive providers have long been criticised for lack thereof.

According to Fred Kooij, CIO at Tribe Impact Capital, "in their current form, ETFs and passive vehicles are not the right tool to place money into the market if you're seeking to achieve both financial and positive impact return".

He argues that "investing for impact can't be silent on what a company does", and the fact that passive funds cannot exercise voting rights means they "become as much a part of the problem as their holdings are".

However, leading passive providers say they are far from powerless when it comes to engagement, arguing that they are able to use their scale to put pressure on all companies they invest in, whether actively or passively. Tom McGillycuddy, founder of impact investing app Tickr, said: "Engagement is all about who owns the companies, and how much clout they have. BlackRock is the biggest passive manager in the world, but do you think they do not engage with the companies they own through their ETFs? They do, frequently. Why? Because they are the biggest investors in the world, so whether they hold those companies in ETFs or active funds, it does not matter."

In fact, according to Manuela Sperandeo, head of EMEA smart beta, sustainable and thematic ETFs at BlackRock, being unable to sell positions from an index fund means passive providers have no choice but to engage in order to fulfil their stewardship responsibilities.

"Over the past 12 months, this approach saw us vote against management at 53 companies, where we found corporate leadership unresponsive to investors' concerns about climate risk or assessed their disclosures to be insufficient given the importance to investors of detailed information on climate risk and the transition to a low-carbon economy," she said.

Although the lack of common impact investing standards is a challenge for the industry, there are frameworks against which investors can measure the impact of their ETFs. The most commonly used are the UN Sustainable Development Goals – 17 global goals aiming to achieve a more sustainable future for humanity

INDEX CONSTRUCTION

When it comes to constructing an index to create positive impact, there are a number of options available to passive providers. In the early days, exclusion was the most commonly applied strategy, but today products are becoming more sophisticated. For example, Sonja Laud, CIO at Legal & General Investment Management, said the firm has started using tilting mechanisms to create ETFs that produce "tangible effects with regards to carbon footprinting, for example".

Laud said LGIM is particularly focused on developing passive decarbonisation strategies, and it is not alone. This year has seen the launch of a number of climate change ETFs and smart-beta products aligned with the Paris Agreement goals, including offerings by Lyxor, Franklin Templeton, Amundi and Ossiam. Tickr, which currently uses ETFs from BlackRock, UBS Asset

Management and Lyxor to construct diversified impact themes, also plans to launch its own suite of impact ETFs starting next year, covering climate, equality and disruptive tech.

Tickr's McGillycuddy said creating impact ETFs is all about investing in companies that already have a positive impact, such as renewable energy, "therefore driving attention towards them, driving positive news, driving up their stock price, which in turn allows them to raise capital at cheaper rates and expand their operations, therefore expanding their impact".

"If you take the 50 best companies for impact in the world, and invest in them all, that is impact," he continued. "This is how we will construct out ETFs - impact first (by using our own impact methodology) which leaves us with a basket of high impact companies; we then create an index from this and launch an ETF. We think active returns - for the fees paid - are not worth it."

GLOBAL STANDARDS

Meanwhile, although the lack of common impact investing standards is a challenge for the industry, there are frameworks against which investors can measure the impact of their ETFs. The most commonly used are the UN Sustainable Development Goals (SDGs) – 17 global goals aiming to achieve a more sustainable future for humanity.

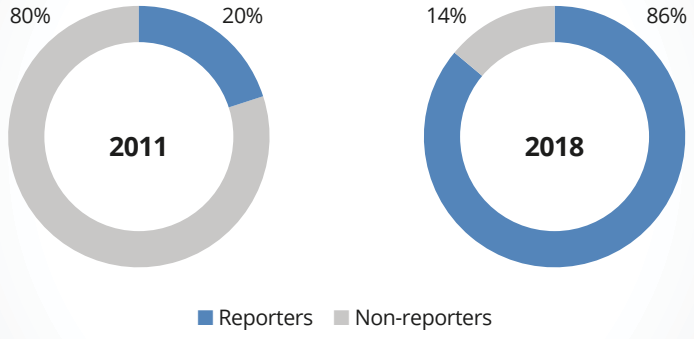
According to UNCTAD, all thematic ESG ETFs in Europe, which made up around 20% of the European ESG ETF universe, target specific SDGs. The range of such thematic funds continues to grow, with recent launches covering such themes as gender equality, water and sustainable food.

Rahul Bhushan, co-founder of Rize ETFs, which recently launched ETFs focusing on sustainable food and digital learning, said many of the ESG ETFs available in the market are "benchmark minus" products, investing in an index such as the MSCI World minus alcohol, tobacco and coal.

"Instead, we wanted to create 'theme plus' products," Bhushan said. "We started with education and food. Education is SDG 4, while sustainable food touches a broad range of areas when it comes to SDGs."

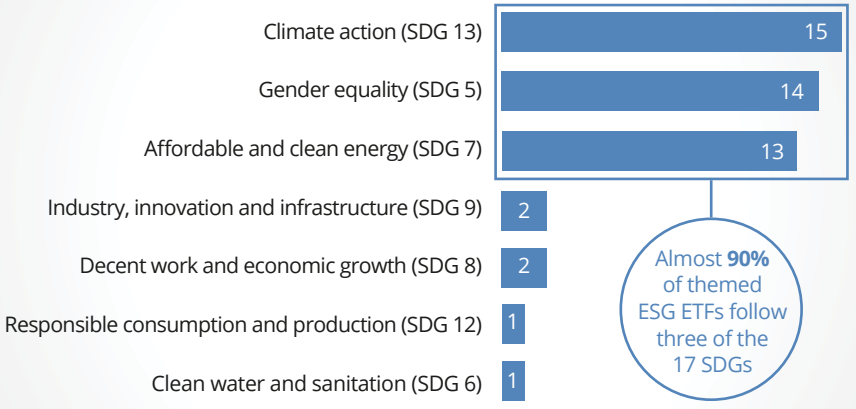
However, UNCTAD noted that the majority of existing products cover just three SDGs, while 10 of the 17 goals are not targeted at all, so there is still much room for development. Future innovation in this area will depend on whether we see continued strong demand for impact ETFs from investors.

CHART 1. MORE COMPANIES ARE REPORTING ESG INFORMATION



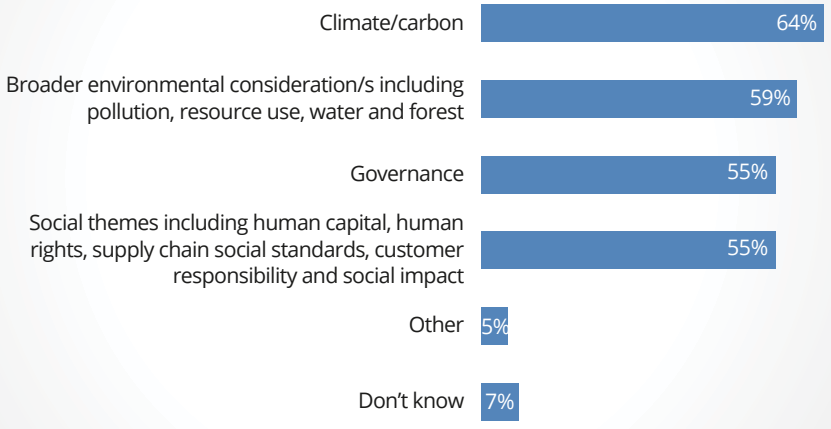
Source: Governance & Accountability Institute, 2019, based on companies within the S&P 500.

CHART 2. RANKING OF SDGS BY NUMBER OF THEMED ESG ETFS, 2019



Source: UNCTAD calculation based on TrackInsight data

CHART 3. WHAT ESG/SUSTAINABILITY ISSUES ARE YOU CONSIDERING USING IN A SMART BETA AND ESG ALLOCATION



Multi-pick. Segment = Anticipate applying ESG/sustainability considerations to a smart beta strategy

RETURN TO CONTENTS

Exploring ESG as a risk factor

Can ESG be a factor? Thierry Roncalli, head of quantitative research at Amundi, explores why incorporating ESG metrics can improve the risk profile of a portfolio

Can we consider that ESG has become a new risk factor, exactly like the traditional factors of factor investing, such as size, value, momentum, quality, or low volatility/low beta? This is an important question, and answer really is not easy.

A number of published Amundi research[1] papers show that the relationship between ESG and performance is not static, but dynamic; sometimes ESG may create performance, and sometimes destroy it. This research has shown that ESG investing tended to penalise both active and passive investors between 2010 and 2013, but drove outperformance and positive alpha between 2014 and 2017 in Europe and North America.

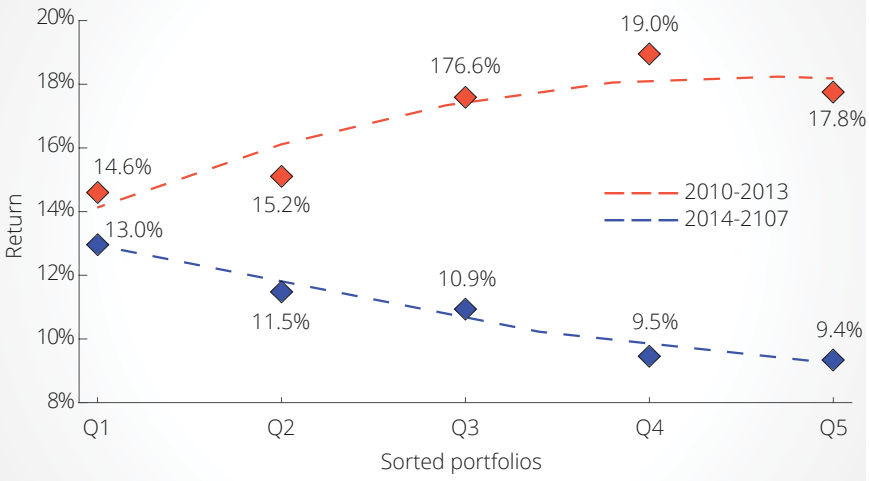
The reason for this change was the extrinsic value of ESG investing, i.e. investment flows and the mobilisation of investors, especially in Europe, which created a positive bubble for ESG assets.The 2018-19 period, meanwhile, continues this trend, with ESG delivering positive alpha, but with the eurozone increasingly outpacing North America, and the social pillar emerging to overshadow environmental and governance as the main performance driver in the 2018-2019 period. re, ESG investing has grown more complex, with stock pickers going beyond simple exclusion or inclusion strategies to capitalize on the dynamics of ESG scores.

Can we assume that ESG is a new risk factor? It is important to recognise first that risk factors in investing are different matters from risk factors in business risk management, such as carbon risk, which must be actively managed. Factor investing focuses on the difference between performance from systematic factors and specific factors, or between alpha and beta. Several betas – market risk, size, value, momentum, low volatility, quality, etc. – are usually at play.

Based on single-factor regression of the MSCI World index, we find that specific factor risk has increased in 2014-19, and that ESG has beaten every other single factor except the market factor in that period, in both North America and the eurozone – although its influence is less marked in a multi-factor framework. In North America, ESG is valuable for poorly diversified portfolios, but less so for highly diversified ones, but in the eurozone it retains its importance.

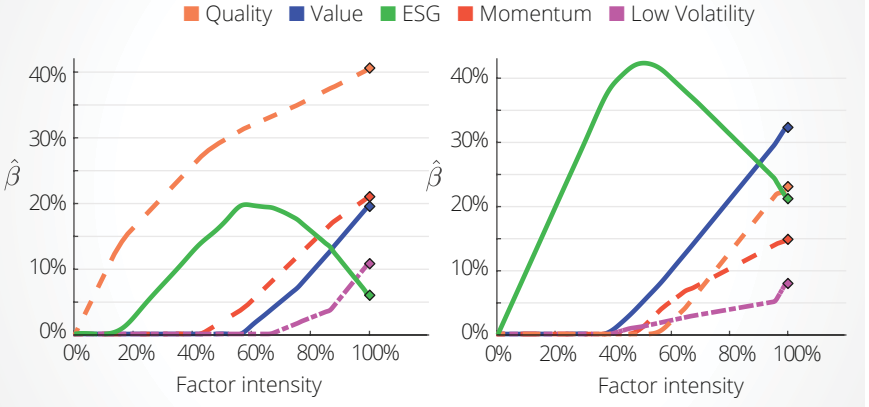
In summary, "ESG remains an alpha strategy in North America," and becomes a beta (or risk factor) strategy in the eurozone – due basically to ESG's underlying market share in each region. North America ESG, we believe, will eventually follow suit as market share increases.

TABLE 1. ANNUALISED RETURN OF ESG SORTED PROTFOLIOS (NORTH AMERICA)



Source: Amundi Quantitative Research

GRAPH 2. LASSO REGRESSION ANALYSIS BETWEEN 2014 AND 2019



Source: Amundi Quantitative Research

Carbon risk is another ESG related area that has been a focus recently and some have questioned its role as a factor. A further Amundi research paper, Measuring and Managing Carbon Risk in Investment Portfolios, advises caution in treating the carbon risk factor in the same way as the ESG factor for the diversification of a portfolio from a factor investing perspective.

In fact, carbon risk, included in the environmental pillar of ESG, represents a narrow investment type and cannot be regarded as a key investing theme for institutional investors. Therefore, this newly introduced market-based carbon risk measure, the carbon beta, is especially useful from a risk management perspective. It provides an applicable measure of carbon risk that can be used in traditional portfolio construction methods, such as minimum variance strategies or enhanced index portfolios through a risk overlay or a bottom-up approach to control the carbon risk.

Research has shown that ESG investing tended to penalise both active and passive investors between 2010 and 2013, but drove outperformance and positive alpha between 2014 and 2017 in Europe and North America

[1] How ESG investing has impacted the asset pricing in the equity market, 2018 and ESG investing in recent years: new insights from old challenges, 2019.

Thierry Roncalli joined Amundi as Head of Quantitative Research in November 2016. Prior to that, he was Head of Research and Development at Lyxor Asset Management (2009- 2016), Head of Investment Products and Strategies at SGAM AI, Société Générale (2005-2009), and Head of Risk Analytics at the Operational Research Group of Crédit Agricole SA (2004-2005). Thierry began his professional career at Crédit Lyonnais in 1999 as a financial engineer. Before that, Thierry was a researcher at the University of Bordeaux and then a Research Fellow at the Financial Econometrics Research Centre of Cass Business School.

RETURN TO CONTENTS

ESG data: Dazed and confused

There are over 600 ESG rating frameworks. Nicolas Rabener, founder and CEO of Factor Research, analyses why this lead to investors doubling up on the same risk exposures

The ESG ecosystem has three groups of players – the data providers, the asset managers and index providers (data consumers), and the asset allocators. Unfortunately, it is a rigged game with only one clear winner – the data providers that sell ESG ratings. Current demand for anything ESG allows asset managers and index providers to charge more for ESG than for plain-vanilla products, but there is the additional cost of buying data, hiring quant analysts to dissect and organize the data, and spending money on marketing.

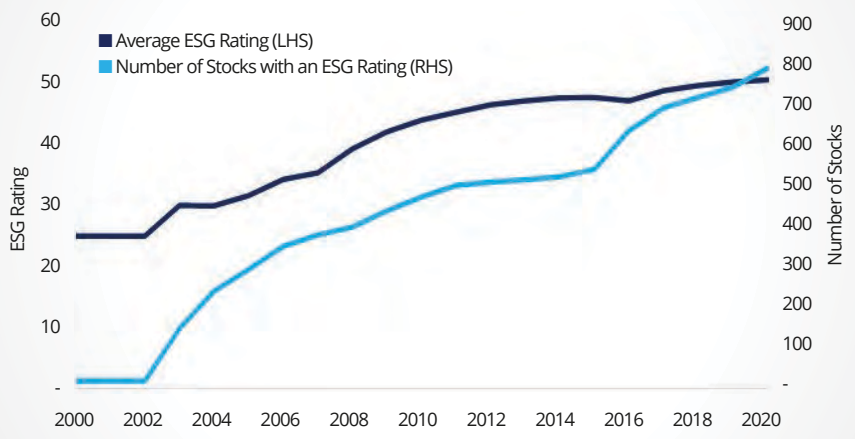
There are second-order benefits to asset managers like reducing the emphasis on short term performance ("Don't mind how badly value is doing, rather look here at how great our ESG positioning is!"). The asset allocators, and ultimately their clients, are most likely the losers as they are financing this "feel-good" ecosystem, with little evidence supporting the idea that ESG investing generates consistent outperformance.

The market for ESG data is expected to grow by 20% and reach $1bn in 2021 as per a recent research note by Opimas, a management consultancy. The growth in data spending is mirrored by a significant increase in the assets under management in global ESG ETFs, which have increased by $38bn to more than $100bn in the first eight months of 2020, according to data from ETFGI, a data provider.

It is precisely because of the strong momentum of the ESG industry that investors need to be cautious in evaluating ESG data, which has become increasingly complex given the abundance of options. As of today, there are more than 600 ESG rating frameworks as reported by the think tank SustainAbility, which makes it almost impossible for investors to evaluate all of them. Furthermore, some ESG methodologies result in strong sector and factor biases, which can lead investors to unknowingly double up on the same risk exposure.

Having said this, not all data providers have the same methodology, and the complexity of ranking companies provides an opportunity for differentiation. In this short research note, we will evaluate the ESG data set of a well-known provider by asking the simple question: what are we buying and what are we selling when using this data?

GRAPH 1. AVERAGE ESG RATING & NUMBER OF STOCKS COVERED IN THE US



Source: FactorResearch

DEFINING THE ESG UNIVERSE

We will focus on US stocks in this analysis, where the number of companies with an ESG rating in the data set has increased from 20 in the year 2000 to approximately 800 in 2020, covering almost all stocks in the S&P 500.

Somewhat surprisingly the average ESG rating has doubled from 25 to 50 over the same period. An ESG enthusiast might hope that all companies have become better corporate citizens and therefore earned higher ESG ratings, but that assumption is too naive. The increase in the average ESG score is explained by more data becoming available over time and the stocks being evaluated from today's perspective, which is only possible by adjusting the historical ratings. Unfortunately, this implies that year-to-year comparisons are not that useful and ratings should only be evaluated on a cross-sectional, relative basis within a year, which increases the complexity of using ESG data (see Graph 1).

COMPARING GOOD VERSUS BAD CORPORATE CITIZENS

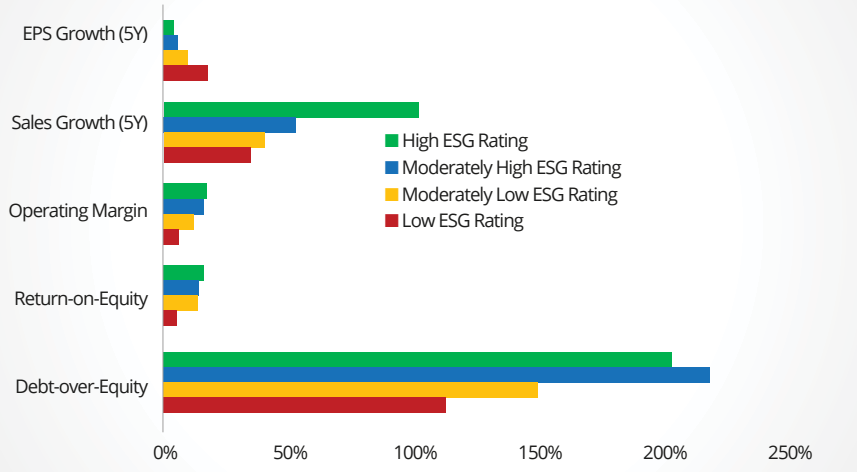
Asset managers and index providers can use ESG data in various ways of constructing ESG-compliant portfolios. Historically, many product providers excluded stocks with low ratings, but that has become less popular in recent years as the approach leads to large tracking errors. For example, the majority of US stock market returns since 2010 are explained by a handful of stocks, primarily the FAANG stocks. If one of these few stocks would have been excluded due to a low ESG rating, then returns would have been significantly lower, which most investors would have struggled with.

Weighting stocks by their ESG scores creates similar issues, which explains why ESG is now typically incorporated on a sector level. However, although this minimises tracking errors, it does lead to exposure to undesired sectors like energy. Asset managers can only hope that clients do not look too closely at the breakdown by sectors in marketing materials as that would infuriate some of them. Fossil-free is not always 100% fossil-free.

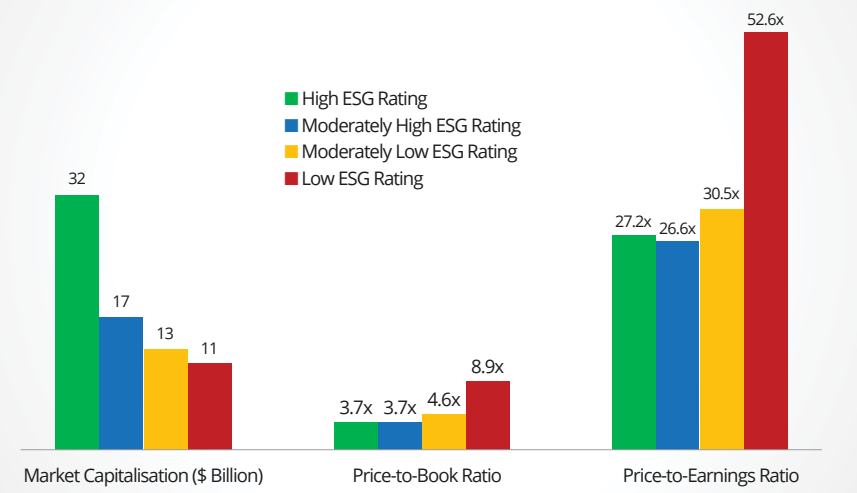
In order to analyse the ESG data set, we separate all 790 stocks into quartiles based on

As of today, there are more than 600 ESG rating frameworks as reported by the think tank SustainAbility, which makes it almost impossible for investors to evaluate all of them

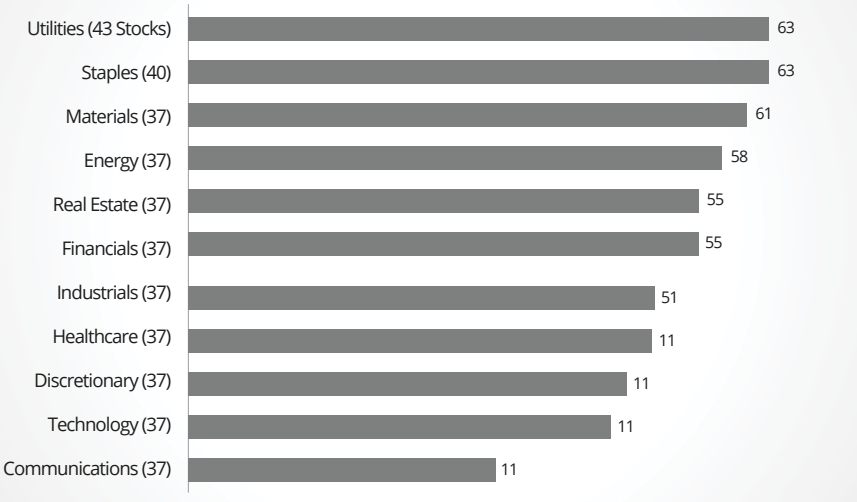
GRAPH 2. GOOD VS BAD CORPORATES: KEY FUNDAMENTAL METRICS (2020)



GRAPH 3. GOOD VS BAD CORPORATES: MARKET CAPS & VALUATIONS (2020)



GRAPH 4. ESG RATINGS BY SECTORS (2020)



their ESG ratings and calculate key fundamental ratios based on the most recent financial data. We observe that companies with high ESG ratings generated lower EPS and sales growth, but also featured higher operating margins compared to stocks with low ratings. Furthermore, good corporate citizens are more profitable, but also more leveraged. Based on these ratios, it is difficult to identify a common thread between stocks with high and low ratings (see Graph 2).

SIZE AND VALUATION BIASES

Next, we analyse the market capitalisations and equity valuations. We observe that stocks with a high ESG rating feature larger market capitalisations, but also lower valuations on average. The negative exposure to the size factor, which is defined as going long small and shorting large caps, is not surprising as large companies have more developed corporate governance and social standards than smaller ones.

They also have dedicated investor relations staff that can focus on fulfilling complicated ESG reporting requirements. However, the positive exposure to the value factor, i.e. buying cheap and selling expensive stocks, is unusual as stocks trading at lower valuations typically represent companies in trouble, where there is little money available for achieving a high ESG rating. In most ESG data sets

stocks with the highest ESG ratings are expensive, which is also a reflection of biases towards sectors like technology (see Graph 3).

INVESTIGATING SECTOR BIASES

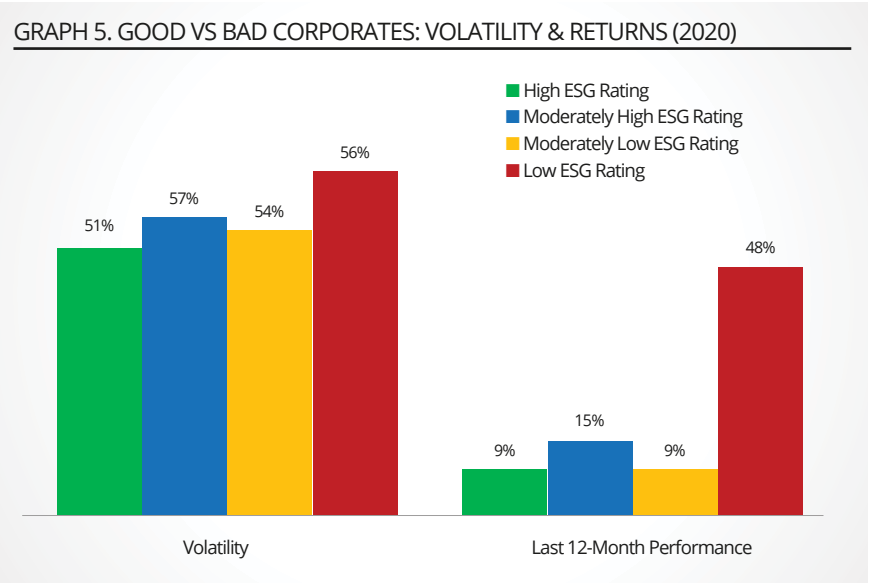
Calculating the average ESG rating per sector also highlights a somewhat odd picture as sectors like energy and materials feature high average ratings, but these stocks are typically at the bottom given low environmental scores. It is worth noting that this data provider calculates ESG scores on a range from 0 - 100 and sector-neutral, but it is difficult to explain why utility stocks have an almost 100% higher ESG score than communication stocks on average. Perhaps this is an indication of companies starting to game the ESG ecosystem, e.g. by disclosing more or only selective information (see Graph 4).

RISK AND RETURNS

Finally, we review the annualised volatility and 12-month performance of the companies ranked by ESG scores, which highlights that stocks with the lowest scores were more volatile, but also generated the highest returns. Given that we are looking back only one year, this should not be regarded as particularly representative of ESG data (see Graph 5).

There is little research that suggests that ESG generates excess returns over the long-term, which data providers and asset managers have acknowledged. Therefore, the focus when marketing ESG has shifted to using ratings in risk management, where a frequent argument is that companies with low ratings have a higher risk of corporate disasters. Naturally, it would be great to be able to avoid stocks like BP before their oil spill in the Gulf of Mexico in 2010.

GRAPH 5. GOOD VS BAD CORPORATES: VOLATILITY & RETURNS (2020)



However, ESG scores can be compared to credit ratings, which have been available for decades and do not seem to have high predictive powers. On the contrary, credit ratings of corporates and governments tend to be downgraded after material events and therefore represent a lagging indicator of corporate riskiness. It is difficult seeing why this would be different with ESG ratings.

FURTHER THOUGHTS

Going back to our original question: what are we buying and what are we selling in this data set?

Well, the companies with the highest ESG ratings are large companies trading cheaply and featuring positive as well as negative fundamentals. Overall, we are somewhat dazed and confused by this characterisation, however, that is not necessarily a negative. It seems you are buying ESG aware companies, although not in the way that it was intended.

Most ESG data sets feature the same sector (long technology, short energy stocks) and factor (long quality, short value) bets, which can lead investors to be exposed to more of the same risk, e.g. by holding a technology and an ESG ETF. In fact, the portfolio characteristics of this ESG data set could be regarded as positive from a factor investing perspective given the tilt to large-cap value stocks.

Nicolas Rabener is the managing director of FactorResearch, which provides quantitative solutions for factor investing. Previously he founded Jackdaw Capital, an award-winning quantitative investment manager focused on equity market neutral strategies. Rabener holds a Master of Finance from HHL Leipzig Graduate School of Management, is a CAIA charter holder and enjoys endurance sports.

RETURN TO CONTENTS

The impact of ESG integration on fixed income portfolios

Should ESG be considered a factor? Maria-Laura Hartpence, head of fixed income quantitative research at HSBC Global Asset Management, argues while we are not there yet, combining ESG with fixed income does not harm returns

Maria-Laura Hartpence is head of fixed income quantitative research at HSBC Global Asset Management

Stegies that integrate environmental, social and governance (ESG) factors in their investment process have outperformed during the ongoing COVID-19 crisis. Our own analysis confirms these results. Nevertheless, we think that the analysis of the observations made during unprecedented circumstances should not be the sole driver of institutional long-term fixed income allocations. We decided to put these findings into perspective by looking at a broader time period, from 2007 to June 2020. We find this period relevant because it coincides with the Global Financial Crisis and strong implementation of unconventional monetary policies which after an eventual pause, resumed again with the COVID-19 crisis.

Using our quantitative fixed income research capabilities, we aimed to establish the extent to which issuers with better ESG scores can enhance portfolio returns over different market conditions. In this research paper, we wanted to quantify the impacts of ESG factors on the quality and performance of investment grade corporate and government bonds.

METHODOLOGY

We backtested the performance of monthly rebalanced long short (L-S) portfolios, where we went long (short) for relatively higher (lower) ESG-rated bonds, with each portfolio conditioned on either the overall ESG score, a different ESG pillar (either environmental, social or governance factors) or sub-scores covering specific ESG issues. Bond risk was taken into account in the portfolio construction. We did this for corporate and sovereign bonds for both developed and emerging markets, and for different chosen segments (selected country groups for sovereign bonds, ratings and sectors in the case of

EXHIBIT 1: SHARPE RATIO OF L-S SOVEREIGN BOND PORTFOLIOS CONDITIONED ON DIFFERENT ESG SCORES (BACKTEST PERIOD: JANUARY 2012 TO JUNE 2020)

	DM	DM	EM	EM	EM	EM
	All DM countries	US, UK, JP, Germ, Aust	All EM countries	Europe	Latin America	Asia
Government ESG Score	0.04	0.08	0.44	0.43	0.2	0.14
Risk Management	0.14	0.14	0.64	0.58	0.11	0.23
Risk Exposure	0	-0.04	0.06	0.03	0.22	0.06
Governance Risk S	0.04	0.09	0.47	0.37	0.2	0.31
Social Risk	0.11	0.24	0.63	0.59	0.27	0.31
Environmental Risk	0	-0.05	-0.52	-0.14	-0.05	-0.47
Governance Risk Management	0.06	0.16	0.56	0.54	0.14	0.18
Social Risk Management	0.23	0.24	0.64	0.63	0.14	0.38
Environmental Risk Management	0.27	-0.08	-0.27	0.27	-0.15	-0.34
Governance Risk Exposure	0.02	-0.06	0.26	-0.03	0.23	0.32
Social Risk Exposure	0.02	0.03	0.58	0.56	0.22	0.24
Environmental Risk Exposure	-0.05	-0.02	-0.52	-0.19	0.02	-0.52

Source: HSBC Global Asset Management - Fixed Income Quantitative Research calculations.
Figures refer to simulated past performance. Simulated past performance is not a reliable indicator of future performance.
Investment involves risks. Any forecast, projection or target contained in this presentation is for information purposes only and is not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecasts, projections or targets. For illustrative purposes only.

EXHIBIT 2: LONG ONLY CORPORATE STRATEGIES: SHARPE RATIO AND INFORMATION RATIO OF SIMULATED CORPORATE STRATEGIES WHERE WE WENT OVERWEIGHT (UNDERWEIGHT) RELATIVELY HIGHER (LOWER) ESG QUALITY BONDS
BACKTEST PERIOD: DECEMBER 2012 TO JUNE

			Long only portfolios (where we maximised the exposure to the ESG factor under TE constraints)		Information ratio relative to benchmarks	
		Benchmark* Sharpe ratio	Sharpe ratio before transaction costs	Sharpe ratio after transaction costs	Information ratio before transaction costs	Information ratio after transaction costs
USD IG	ESG	0.69	0.83	0.78	0.18	0.03
	E	0.69	0.96	0.90	0.63	0.46
	S	0.69	0.72	0.67	0.00	-0.20
	G	0.69	0.73	0.67	0.08	-0.12
EUR IG	ESG	0.79	0.92	0.86	0.32	0.07
	E	0.79	0.95	0.88	0.69	0.29
	S	0.79	0.92	0.86	0.10	-0.16
	G	0.79	0.85	0.79	0.07	-0.18

* ICE BofA ML Global Corporate Index for Corporates - EUR and GBP tranches.
Sources: ICE BofA ML, MSCI, HSBC Global Asset Management, Fixed Income Quantitative Research.
Figures refer to simulated past performance. Simulated past performance is not a reliable indicator of future performance.
Investment involves risks. Any forecast, projection or target contained in this presentation is for information purposes only and is not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecasts, projections or targets. For illustrative purposes only.

corporate bonds). We also backtested benchmarked strategies of long-only portfolios for investment grade corporate bonds in developed markets, in a more realistic setting, taking into account transaction costs.

To proceed, we used MSCI ESG scores. Bond portfolios' performance was measured by 5-year CDS returns in the case of sovereign bonds, and by bond excess returns on cash in the case of corporates.

OUR FINDINGS ON SOVEREIGN BONDS

In the case of sovereign bonds, the construction of portfolios which went long for the highest-ESG rated bonds and short for the lowest ESG rated bonds delivered positive risk-adjusted returns for emerging markets. Incorporating the Social and Governance factors yielded significant positive results while the integration of environmental issues in sovereign bond portfolios did not yield significant performance results. The results were a lot less significant in developed markets. We believe that these results could very well change in the future, in particular with the growing importance of environmental factors and the international treaties being signed to fight against climate change, governments will be increasingly scrutinised by agencies and markets in this context.

OUR FINDINGS ON INVESTMENT GRADE CORPORATE BONDS

Our testing of investment grade corporate bond performance in L-S portfolios has revealed that, overall, the integration of ESG factors was effective for issuers in developed markets – but not as significant in emerging / frontier markets. Overweighting corporate bonds with better ESG quality in developed markets delivered positive returns in various market segments, with the environmental factor acting as a key differentiator particularly from 2012 onwards – when MSCI extended its ESG rating coverage – followed by social and governances factors.

We tested ESG signals in long-only investment grade corporate bond strategies in developed markets, where we maximised the exposure to ESG scores while remaining benchmark-constrained on other structure characteristics, such as yield, spread, DTS and sector composition. The portfolios delivered sharpe ratios close to those of the benchmark or slightly higher in EUR and USD portfolios, even after transaction costs. However, information ratios of the ESG portfolios after transaction costs were negative in a few cases as a result of the slightly lower beta of the ESG portfolio relative to its benchmark.

IN CONCLUSION

Given that ESG scores have not been in use for very long, we can't say that an "ESG factor" has been identified, but we can comfortably say that the integration of ESG in fixed income portfolios did not harm returns. In fact, during the period of time we analysed, ESG integration added value to investors in most circumstances. Nevertheless, we must stress that since ESG high rated bonds tend to have a lower beta, taking into account ESG factors in a fixed-income investment solution necessitates an informed and sensible portfolio construction in order to mitigate unwanted bias.

Disclosure

This is based on the fact ETF Stream has had sight of the disclaimer and are satisfied that it will only be distributed to clients relevant to the European countries specified in the important information disclaimer on the original document.

RETURN TO CONTENTS

How European investors consider introducing ESG with ETFs and in factor investing

Véronique Le Sourd, senior research engineer at EDHEC-Risk Institute, analyses the latest trends from across the ESG ETF space following the release of the firm's survey annual factor investing survey

Véronique Le Sourd has a Master's Degree in applied mathematics from the Pierre and Marie Curie University in Paris. From 1992 to 1996, she worked as a research assistant in the finance and economics department of the French business school HEC and then joined the research department of Misys Asset Management Systems in Sophia Antipolis. She is currently a senior research engineer at EDHEC-Risk Institute.

Since 2006, EDHEC-Risk Institute has annually surveyed European professional investors about their views and uses of ETFs, and more recently about their use of smart beta and factor investing strategies, as part of the Amundi research chair at EDHEC-Risk Institute on ETF, Indexing and Smart Beta Investment Strategies.

This thirteenth edition of the survey[1] made a focus on ESG investing, both in the context of ETFs, and smart beta and factor investing strategies, and highlighted a growing interest in the integration of an ESG component into investment. The high level of interest among respondents in ESG was remarkable. It was not mandatory to answer ESG questions and yet at least 95% of respondents did so. Here we provide a summary of the survey results related to ESG topic.

The EDHEC European ETF, Smart Beta and Factor Investing Survey 2020 took the form of an online questionnaire addressed to European professionals in the asset management industry. It targeted institutional investors, as well as asset management firms and private wealth managers.

Our 191 respondents were high-ranking professionals within their organisations (49% belong to executive management and 29% are portfolio managers), with large assets under management (35% of respondents represent firms with assets under management exceeding €10bn). Respondents were distributed across different European countries, with 15% from the United Kingdom, 65% from other European Union member states, 16% from Switzerland and 4% from other countries outside the European Union.

HOW INVESTORS VIEW ESG?

Throughout the survey, investors were asked about their positions with regards to ESG criteria. First, they were asked about the reasons they find it important to incorporate ESG into investment decisions. It appears that the two main reasons for respondents to incorporate ESG is to allow for a positive impact on society (65%) and to reduce long-term risk (58%) (see Table 1).

Interestingly, Table 1 shows that only a quarter of them (25%) think that incorporating ESG will serve to enhance portfolio performance. However, when respondents were asked if they were willing to accept a lower performance in exchange for a better ESG score, 63% of them answered they were not. It will therefore be important to find the right

Over the years, our surveys have shown a wide adoption of ETFs to invest in the main asset classes, with 92% of respondents using ETFs to invest in equities in 2020, and 97% being satisfied with them, high levels that have been observed for a decade. For other asset classes, such as ESG and smart beta and factor investing, the use of ETFs has developed more recently

EDHEC-RISK Institute

balance between the ESG score and the portfolio performance. The majority of respondents (57%) identify the E (environmental) as the most important dimension of ESG. The G (governance) comes second (36%) and the S (social) ranks last with only 7% of respondents considering it to be the most important dimension of ESG (see Table 2). This ranking is not surprising considering the current strong concerns about climate change. Respondents were asked in the survey to indicate their preferred approach to ESG. From Table 3, it appears that the best-in-class (i.e. positive screening) approach comes far ahead of the other two, with 45% of respondents preferring it, compared with 30% for the thematic approach and 25% for the negative screening approach.

HOW INVESTORS INCORPORATE ESG INTO ETFS AND HOW THIS USE WILL DEVELOP IN THE FUTURE?

Over the years, our surveys have shown a wide adoption of ETFs to invest in the main asset classes, with 92% of respondents using ETFs to invest in equities in 2020, and 97% being satisfied with them, high levels that have been observed for a decade. For other asset classes, such as ESG and smart beta and factor investing, the use of ETFs has developed more recently. It is interesting to compare the respective evolution of these two asset classes within ETF investment over the years.

In 2011, only 17% of respondents were investing in ESG, compared to about one in two respondents (49%) in 2020, of whom 55% have used ETFs to invest in ESG in 2020, whereas the figures were only 22% in 2011 and 33% in 2019 (see Table 4). Aggregating these results, we see that more than a quarter (27%) of ETF users were using ETFs based on ESG in 2020, compared to only 4% in 2011. The significant development in the use of ETFs to invest in ESG was observed not only in the rate of usage, but also in the intensity of usage, as ETFs accounted for 39% of total investment in ESG in 2020, compared with 13% in 2011. In addition, 87% of respondents using ETFs to invest in ESG are currently satisfied with them.

Respondents were also asked how they intend to use ETFs for incorporating ESG into their portfolio. Table 5 shows that the answers are fairly well distributed between the three propositions, even if "replacing standard ETF exposures by ESG exposures" comes first with 41% of respondents mentioning it. The two other propositions "introducing ESG in equity or fixed-income ETFs" and "using ETFs within a specific ESG portfolio" are not far behind with 37% and 36% of respondents, respectively, considering doing that (see Table 5).

TABLE 1: DO YOU THINK INCORPORATING ESG CONSIDERATIONS IS IMPORTANT IN INVESTMENT DECISIONS TO...

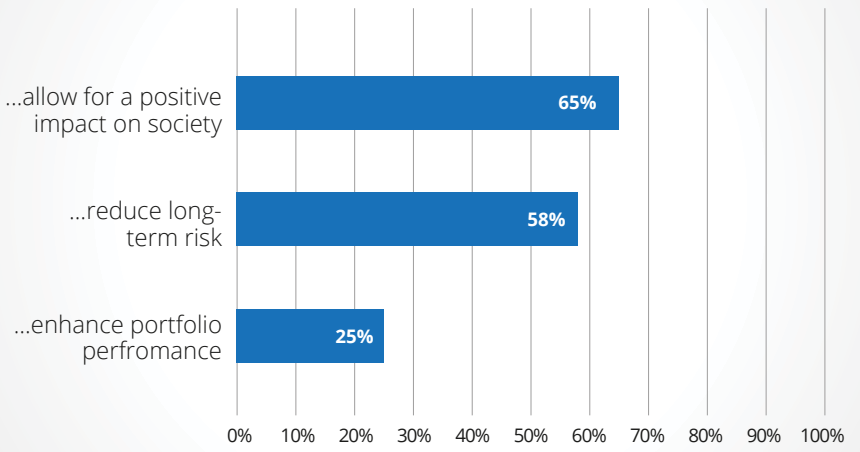


TABLE 2: MOST IMPORTANT DIMENSION OF ESG

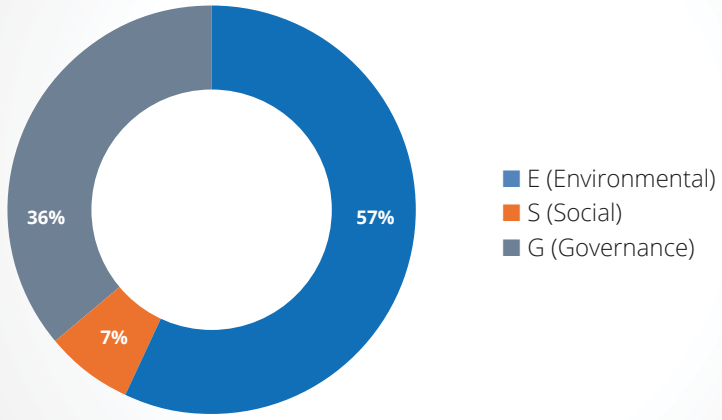


TABLE 3: PREFERRED APPROACH TO ESG

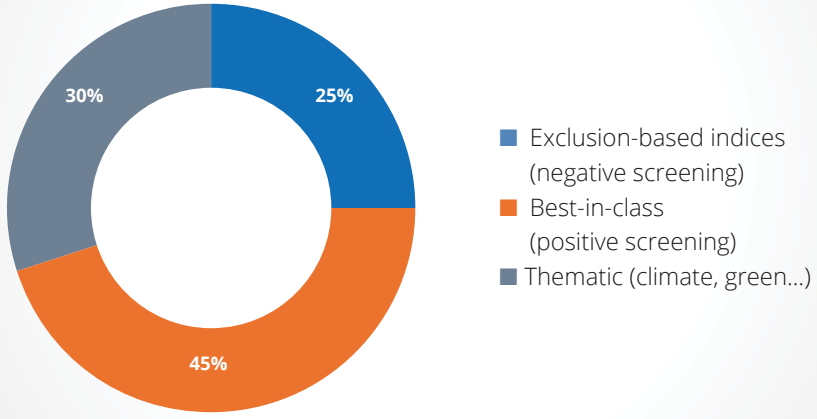


EXHIBIT 4: ESG ETF USAGE

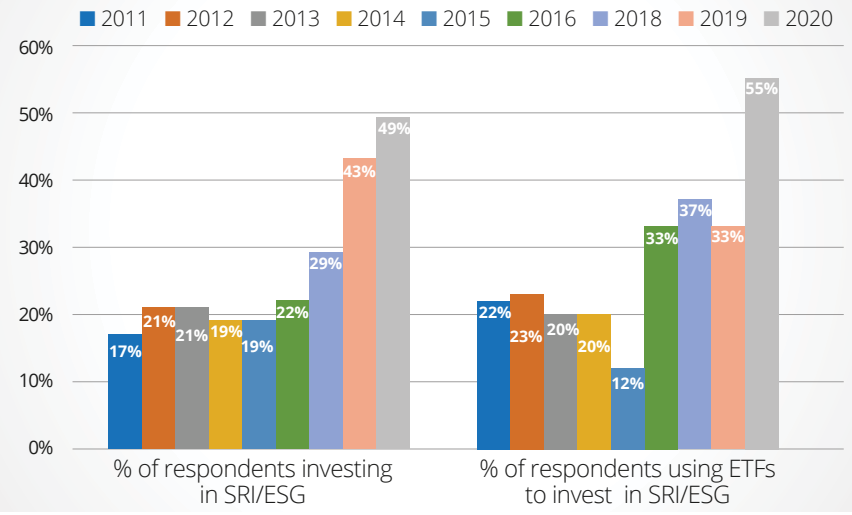


EXHIBIT 5: USE OF ETFS FOR INCORPORATING ESG INTO THE PORTFOLIO

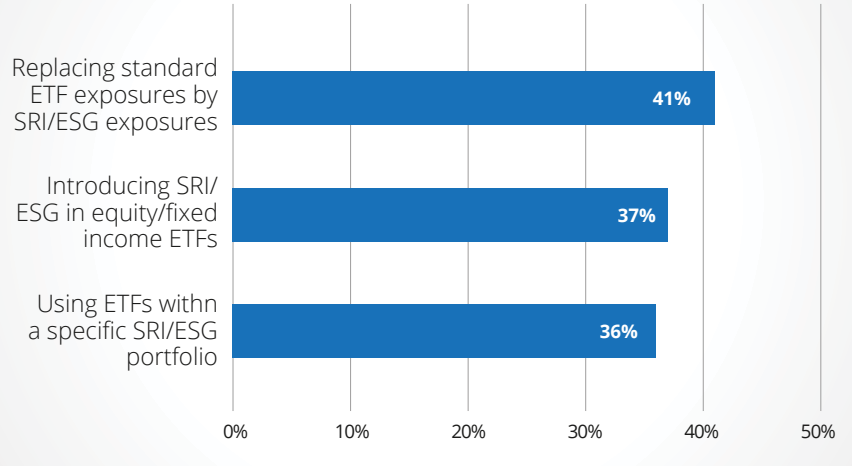
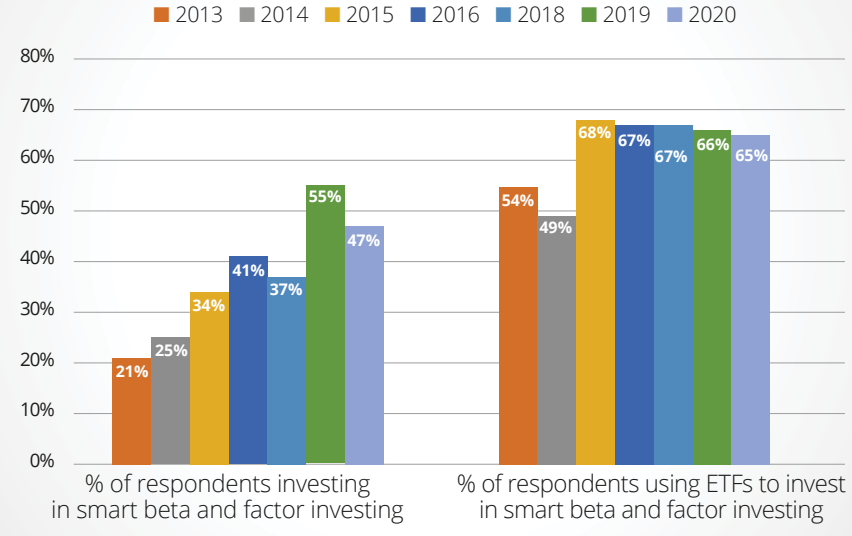


EXHIBIT 6: SMART BETA AND FACTOR INVESTING ETF USAGE



SMART BETA AND FACTOR INVESTING ETFS

Some 65% of respondents were using ETFs to invest in smart beta and factor investing in 2020, versus 66% in 2019, a proportion which has remained fairly stable since 2015, with a slight downward trend. If we look at the proportion of respondents investing in this asset class, we also see a decline: 47% in 2020, compared to 55% in 2019 (see Table 6). However, ETFs remain an appealing instrument for this asset class, as 47% of investment in smart beta and factor investing was made through ETFs in 2020, versus 38% in 2019, and 77% of respondents were satisfied with them.

FUTURE DEVELOPMENT OF ETFS

In 2020, 54% of investors plan to further increase their use of ETFs in the future, despite the already high maturity of this market and high adoption rates. The top concern for 43% of respondents is currently the further development of ESG ETFs. In second position, 31% of respondents called for more development of low-carbon ETFs. Additionally, for ETFs related to advanced forms of equity indices – namely those based on smart beta and multi-factor indices – 29% and 25% of respondents called for further developments in these two areas, respectively (see Table 7).

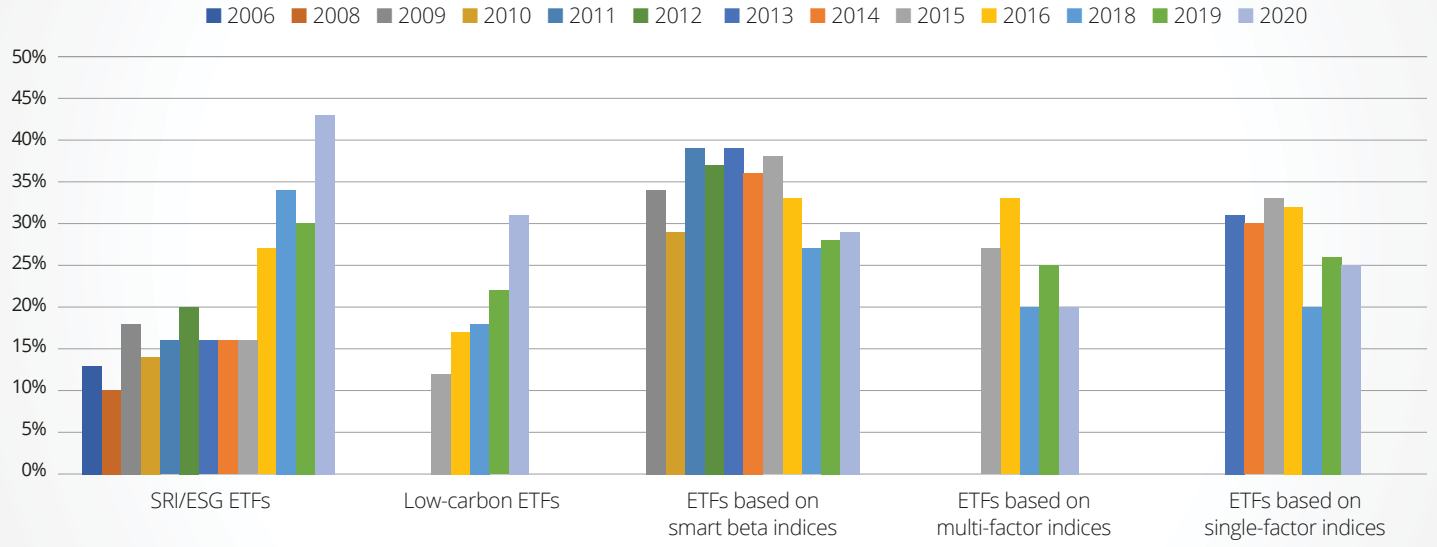
If we aggregate the responses concerning ESG and low-carbon ETFs, we see that 50% of respondents would like to see further developments in at least one of the two categories, compared with 38% in 2019. In the same way, if we aggregate the responses concerning smart beta indices, single-factor indices and multi-factor indices, we see that 43% of respondents would like to see further developments in at least one category related to smart beta equity or factor indices, compared with 45% in 2019.

HOW INVESTORS INTEGRATE ESG WITHIN SMART BETA AND FACTOR INVESTING STRATEGIES AND WHAT FUTURE DEVELOPMENTS ARE REQUIRED?

Survey participants were also invited to give their opinion on smart beta and factor investing strategies beyond their use through ETFs.

The main motivation behind the adoption of smart beta and factor investing strategies is to improve performance. Managing risk is also considered an important criterion. 38% of participants currently invest in smart beta and factor investing strategies; 24% do not but are considering adopting such strategies in the future. However, despite a high rate of adoption, these investments typically make up only a small fraction of portfolio holdings among those respondents who have made investments in

EXHIBIT 7: TYPE OF ETF PRODUCTS TO BE FURTHER DEVELOPED IN THE FUTURE



these strategies. More than two-thirds of respondents (70%) invest less than 20% of their total investments in smart beta and factor investing strategies, and only 13% of respondents invest more than 40%. However, 48% of respondents are planning an increase of more than 10% in terms of assets in their use of smart beta and factor investing products in the near future, while only 7% indicate a planned decrease.

Respondents were asked about the approach they consider to be the best in reducing a portfolio's carbon footprint within smart beta and factor investing strategies. 45% of them consider the best approach is positive screening. Portfolio optimisation comes in second position (32% of respondents). Lastly, only 23% of respondents consider negative screening as the best approach (see Table 8).

In addition, about two-thirds of respondents (65%) consider that sector or neutrality constraints are appropriate when using an ESG filter.

FUTURE DEVELOPMENT OF SMART BETA AND FACTOR INVESTING STRATEGIES

ESG, fixed income and alternative asset classes are the main expectations for future development of smart beta and factor investing products. Respondents would also like more customised smart beta and factor investing solutions to be developed (see Table 9).

Smart beta researchers and product providers doubtless must work to integrate ESG concerns into their solutions for smart beta and factor investing strategies to better meet investment demands.

[1] Le Sourd, V., L. Martellini. 2020. The EDHEC European ETF, Smart Beta and Factor Investing Survey 2020. EDHEC-Risk Institute Publication (September).

EXHIBIT 8: BEST APPROACH TO REDUCE A PORTFOLIO'S CARBON FOOTPRINT

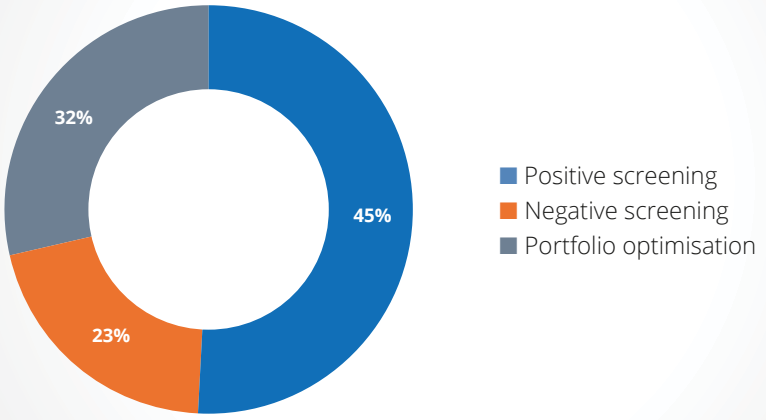
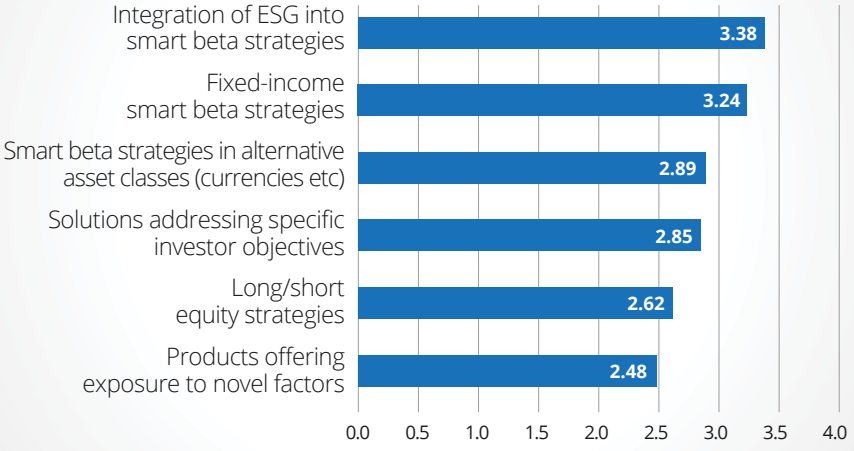


EXHIBIT 9: TYPE OF SOLUTIONS REQUIRING FURTHER DEVELOPMENTS IN THE FUTURE (ON A SCALE FROM 0 – NOT REQUIRED – TO 5 – STRONG PRIORITY).



RETURN TO CONTENTS

Green bonds growing in Europe

Growing concerns about climate change have caused an explosion in "green" bonds among environmentally conscious investors. David Zahn, head of European fixed income at Franklin Templeton, highlights some exciting developments in the green bond market, including new issuance from Germany

David Zahn is the senior vice president and head of European fixed income for Franklin Templeton Fixed Income - Global Sovereign and Emerging Market Debt in London, United Kingdom. Mr. Zahn is responsible for leading the management of European fixed income strategies, and several global aggregate and global government fixed income portfolios.

Green bonds have been growing in popularity as a way to combat the negative effects of climate change across the globe. Similar to traditional bonds in structure, green bonds offer investors the ability to put their money to work in lessening greenhouse gas emissions. Major governments are now getting involved in this space—with European countries taking the lead.

WHAT ARE GREEN BONDS?

Green bonds are capital market instruments used to fund projects that will have a positive environmental and/or climate benefit. According to the Green Bond Principles (GBPs)[1],the issuer needs to certify where and how the proceeds are spent, the process for project evaluation and selection, and the effectiveness of these investments in meeting their decarbonization goals. The GBPs do not require cash to be held in segregated bank accounts or that the assets financed be subject to separate security.

Green bonds made their first appearance in 2008 with an issue from the World Bank. Since then, growing concerns about greenhouse gas emissions and climate change have prompted both a surge in the popularity of environmental, social and governance (ESG) mandates and green impacted-related issuance to finance climate-related expenditures. Green bonds have quickly become common across jurisdictions, industries and currencies.

Issuers seeking the green label for a bond take the additional step of certification, which is typically done by a third party that verifies compliance with the GBPs.

Environmentally conscious investors have seen the attraction of green bonds for several years, but what has changed recently is that the bigger governments are getting involved. European countries are taking a leadership role in this space

GOVERNMENTS GETTING INVOLVED

While companies already aligned with "green" initiatives—such as producers of solar panels or wind turbines—have been a natural fit for green bond issuance, a variety of companies in a range of industries have realised the need to reduce their carbon footprints. Green bonds in general have been growing worldwide in terms of issuance and market size. Global green bond and green loan issuance reached an adjusted $257.7bn in 2019, marking a new global record[2].

Environmentally conscious investors have seen the attraction of green bonds for several years, but what has changed recently is that the bigger governments are getting involved. European countries are taking a leadership role in this space. Germany, Europe's largest economy, recently issued a 10-year green sovereign bond which was met with record demand, raising €6.5bn [3].

What is even more significant is Germany intends to create a green bond curve with the addition of two-year, five-year and 30-year credit instruments. We think this is a very positive development, as it will create a benchmark curve in the green bond space for new issuers to trade off of. Germany is "twinning" these bonds—there will be a green bond with the same coupon and maturity as a conventional government bond. The characteristics are the same, but the proceeds are to be used differently. The importance of this is that the premium investors will pay for green bonds will be readily apparent as the difference in yield will be for the greenness.

Europe has made the greening of its economy a priority, and the financial costs of these efforts require the government to work with the private sector to meet their goals. The European Union (EU) recognises the crucial role of financial markets in capital raising. A third of the EU's coronavirus rescue fund and €1trn of its seven-year budget are earmarked for initiatives directed

at fighting climate change and achieving carbon neutrality by 2050. The greening of Europe is naturally very supportive for the green bond market, and we would expect more issuance and a broadening of issuance to support this focus.

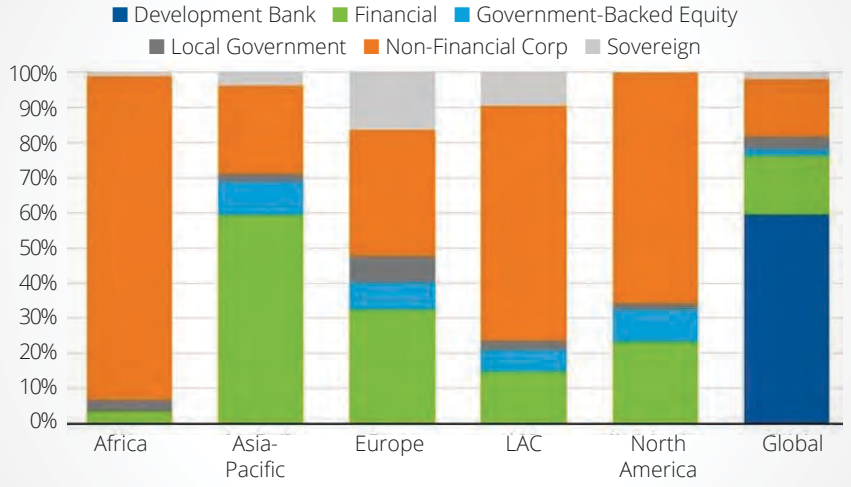
A COMMITMENT TO DECARBONISE

The European Commission has made a clear commitment to remain at the forefront of decarbonising the economy, with a vision of zero net greenhouse gas emissions by 2050. In her State of the Union speech this month, European Commission President Ursula von der Leyen upped the ante significantly on the EU's already-ambitious goals in regard to cutting emissions. She proposed a new target of 2030 to achieve a 55% reduction in emissions versus 1990 and suggested that €225bn in green bonds should be issued to raise money for the 30% of the EU's coronavirus recovery fund directed toward green initiatives. The issuance of the EU green bonds will expand the Euro green bond market significantly and allow Europe to increase its lead as the place to issue green bonds.

The European Central Bank (ECB) has also been supportive of the green bond market. As of the end of 2019, the ECB possessed nearly a quarter (24%) of eligible euro-area public sector green bonds and 20% of eligible euro-area corporate green bonds[4]. More recently, ECB governor Christine Largarde has reiterated it is an area of focus for the central bank. So not only do we have new major sovereign issuers in the form of Germany and the European Union, but a central bank that looks to be a willing buyer. It seems as if Europe has plenty of support among its leadership to become the green bond capital of the world.

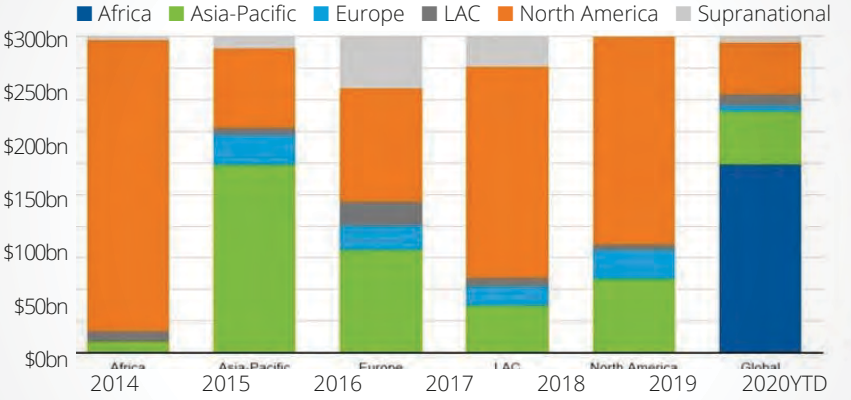
Over the next few years, we believe the green bond market will continue to grow as more investors recognise they do not have to sacrifice yield when following their conscience and can make a positive impact on the future. As investors ourselves in this space, we believe an active approach helps us uncover the most compelling risk-reward opportunities that also provide environmental benefits.

TABLE 1. TYPES OF GREEN BOND BY REGION (REGIONAL ISSUE TYPE SPLIT, AS AT 2019)



Sources: Franklin Templeton Capital Markets Insights Group, Bloomberg, 2019

GRAPH 2. EUROPE LEADS GROWTH IN GREEN BONDS (2014-23 SEPTEMBER 2020)



Sources: Franklin Templeton Capital Markets Insights Group, Bloomberg.
Year-to-date through 23 September 2020. Includes corporate and government green bonds

[1] Source: International Capital Market Association.
[2] Source: Climate Change Initiative, February 2020; data as at 2019.
[3] Source: Bloomberg, "Germany Seizes on Demand for Green Debt with $7.7 Billion Debut," 1 September 2020.
[4] FTSE Russell, "ECB developing an appetite for green bonds," 10 July 2020.

RETURN TO CONTENTS

Is ESG changing how we think about beta?

Michael John Lytle, CEO of Tabula Investment Management, argues fixed income could lead the way when it comes to sustainable investing. Here's why...

TABULA

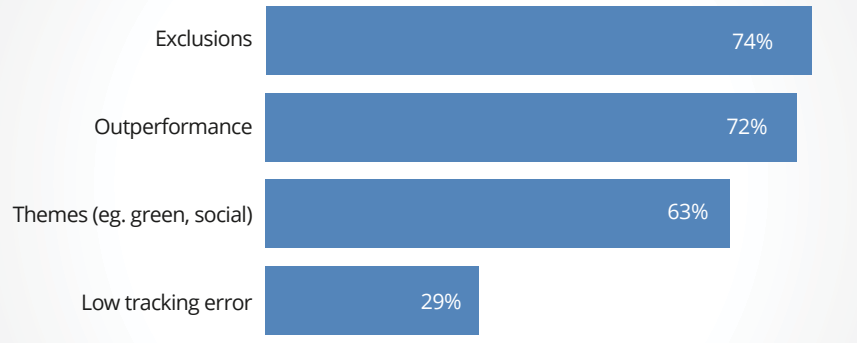
From ethical investing to ESG integration to impact investing, we are seeing a meaningful shift in investor behaviour that will inevitably change both the investment business and the structure of global financial markets. Here, I want to discuss the effect on our concept of "beta".

WHY EXCLUSIONS MATTER

Exclusions have had mixed reviews in recent years, and the debate around engagement versus exclusion persists. However, when Tabula conducted an investor survey earlier this year and we asked professional investors what features they looked for in an ESG ETF, "exclusions" was the top answer (see chart).

What lies behind this is a growing consensus around some minimum basic standards, such as compliance with the UN Global Compact and avoiding manufacturers of controversial weapons. This can be summarised as the "Do No Significant Harm" or "DNSH" principle. While engagement makes sense in some sectors, and particularly for equity investors, some companies and some kinds of business activities are just not ok. Fixed income investing is more suited to exclusions. As a bond investor you vote with your feet. Issuers are in the primary market continuously. If they cannot fund themselves, they will change their behaviour.

CHART 1: WHAT DO YOU LOOK FOR IN ESG ETFS?



Based on 120 professional investors surveyed in May/June 2020 by Tabula Investment Management ("Tabula") or independent research company Pureprofile. Tabula commissioned Pureprofile to interview professional investors (institutional and wealth managers) across seven European countries.

WHAT DOES THIS MEAN FOR "BETA" AS WE KNOW IT?

Until recently, index providers have been hampered by the range of views on exclusions. They have introduced multiple ESG versions of major indices catering to different ethical or religious viewpoints but have generally left their "flagship" indices unchanged. Now, however, although the range of views remains, the investment community is in increasing agreement that certain companies or issuers don't belong in any portfolio. What we think of as beta is already changing.

The rise of passive investing and widespread use of major indices as benchmarks, in research and in the media means that, for many investors, beta is the index. However, with ESG, investors are leading the way and it is the index providers who need to catch up. Just as indices have always included liquidity filters to ensure "investability", I hope that all major benchmarks will soon incorporate basic ESG filters to ensure responsible "investability". For ETF providers like Tabula, a core component of the ESG strategy should be to lobby index providers to make these changes. We have had smart beta; what we need now is "better beta".

HOW MUCH DOES TRACKING MATTER?

Many existing ESG indices aim for a risk profile closely matched to their parent index. A few years ago, when ESG was less mainstream, some investors probably needed the reassurance that a shift in assets would not result in significant tracking differential or a major performance difference. Today, we talk to many investors who are convinced about ESG – particularly basic exclusions or "DNSH" - and less concerned if it causes performance to diverge.

Perhaps the relevance of traditional benchmarks is already waning? The day when tracking error is defined relative to an ESG benchmark, as the rule rather than the exception, cannot be far away.

WHERE DO THE EU CLIMATE BENCHMARKS FIT IN?

The European Commission clearly hopes and expects their new low-carbon indices to become the market standard. The EU Technical Expert Group described Paris-Aligned Benchmarks, which require a 50% initial reduction in GHG footprint relative to the broad market and a 7% year-on-year reduction, as "favouring today the players of tomorrow's economy". Perhaps these Paris-Aligned Benchmarks are "beyond beta" in the shorter term but a good indication of where forward-looking investors could direct assets.

Nevertheless, two features of the EU Climate Benchmarks are particularly relevant to this discussion around beta. Firstly, while focusing on climate, the benchmarks also require basic exclusions that broadly reflect current investor consensus: no companies who violate the UN Global Compact and other societal norms; no manufacturers of controversial weapons and no tobacco companies. This is a sign that what is currently best practice could end up as law, and the clear direction of travel for "beta".

Secondly, these benchmarks are designed to help investors align their portfolios with a 1.5C Paris climate scenario. Despite similar sector exposures, they are quite different in composition and weighting to their traditional counterparts. However, if the broader market is able to reduce emissions in line with the Paris commitments, then the EU Climate Benchmarks would gradually become more similar to the broader market. In an ideal world, where the Paris commitments are met, these EU Climate Benchmarks would converge towards market beta.

In the meantime, however, the differing exposures could generate opportunities. Another interesting conclusion from our survey was the demand for outperformance from ESG strategies. Meeting the Paris climate commitments will require significant change, potentially driven by regulation. In this case, investors who have focused on companies with lower climate-related risk could see better performance.

FIXED INCOME COULD LEAD THE WAY

Traditionally, fixed income has lagged equities in passive investing and ETFs. It is a complex asset class, where indexation has been challenging. With ESG, we believe that fixed income can and should lead.

Firstly, exclusion is potentially more powerful than it is in equity markets. As a passive bond investor, engagement opportunities are limited. We can join collaborative initiatives like Climate Action 100+ (and Tabula is actively doing this). However, the regular issuance cycle in bond markets means that exclusion – effectively withholding funding – can potentially influence issuer behaviour.

Secondly, the growth in green, social and sustainable bonds presents an opportunity to define markets by impacts as well as by traditional countries and sectors. Fixed income indices and ETFs could lead the way as the market looks to redefine beta.

Michael John ("MJ") Lytle is CEO of Tabula Investment Management. Tabula is focused on creating and managing outstanding funds offering investors precise tools for fine tuning fixed income exposure. Previously MJ was a founding partner in Source, an investment manager focused on the creation and distribution of ETFs, including a partnership with PIMCO to create and distribute a range of fixed income ETFs. Source was purchased by Invesco in 2017. Prior to Source, MJ spent 18 years at Morgan Stanley. MJ has a BA in Economics and Government from Dartmouth College with further studies at the London School of Economics.

RETURN TO CONTENTS

The year of ESG

The biggest trend in finance? Kenneth Lamont, senior analyst, passive strategies at Morningstar, analyses the dramatic rise of ESG ETFs this year

Kenneth Lamont is a senior fund analyst for Morningstar. Kenneth covers European passive funds. Before joining Morningstar in September 2013, Kenneth was a research analyst at Mergermarket, where he covered the infrastructure finance sector and previously an associate at Markit, where he held an operational role within the portfolio valuations team.

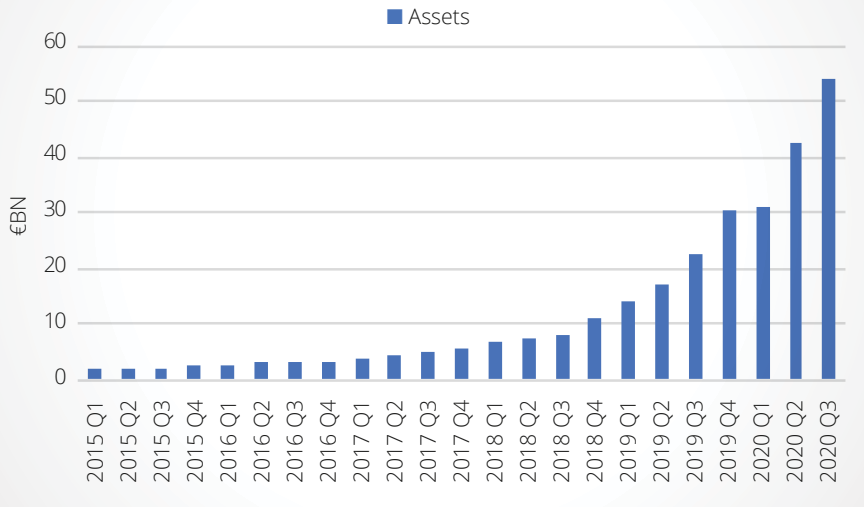
History may well remember 2020 as the year of COVID-19, but for those operating in the European ETF market it may also be remembered as the year of ESG. Assets in sustainable ETFs have nearly doubled to €54.2bn year-to-date. This eye-popping growth has been supported by record net inflows, which have totalled over €22bn.

The uptake has been driven by changing attitudes from both investors and fund providers. This asset growth reflects a growing recognition that ESG factors can be material to long-term financial performance, as companies face greater scrutiny from consumers, regulators, and employees alike over their ESG practices. The crisis caused by the coronavirus pandemic has further highlighted the importance of building sustainable and resilient business models based on multi-stakeholder considerations.

MENU EXPANDS

As assets have begun to arrive en masse, most ETF providers have rushed to launch or expand their sustainability offerings. Seventy-two, or more than half of the ETFs launched in Europe year-to-date integrate sustainable criteria into their investment process.

TABLE 1. EUROPEAN SUSTAINABLE ETF AUM



Year	Number of Launches
2010	2
2011	8
2012	1
2013	1
2014	3
2015	6
2016	7
2017	16
2018	35
2019	33
2020	72

The diverse range of approaches to sustainable investing, combined with the almost infinite number of ways they can be mixed and matched with different markets, asset classes, and investment styles, has fanned the flames of product development. Europe has been the epicentre of much of the sustainable product development.

This year saw the launch of the world's first sustainable ETF targeting the 'blue economy'. The BNP ECPI Global ESG Blue Economy UCITS ETF invests in firms specialising in offshore wind farms and those firms targeting sustainable fishery and marine operations.

THE RISE OF CLIMATE AWARE ETFS

Climate risk has become an increasingly important issue for investors. Assets in climate aware ETFs have more than doubled since the beginning of the year and sit at record levels. Nearly one quarter of all ETF launches in Europe this year has an explicit climate-focus.

New entrants range from the CSIF (IE) FTSE EPRA Nareit Developed Green Blue ETF, which reweights REITs based on their green building certification and energy usage, through to iShares' new range of MSCI Minimum Volatility ESG ETFs, which track low carbon indices.

'PARIS ALIGNED' DESIGNATION

As the popularity of climate investing grows, so do the accompanying accusations of 'greenwashing'. To address this, a number of

index providers have worked with the European Commission to ensure that their strategies are aligned to the Paris Climate Agreement goal to limit global average temperatures to below 2°C above pre-industrial levels.

This goal-focused approach and the stamp of approval from such a respected third party will please many investors. So far, Amundi, Lyxor and Franklin Templeton have all launched 'Paris-aligned' core equity ETFs, and we expect more to follow.

FIXED INCOME GROWS, BUT STILL LAGS

Assets in sustainable fixed income ETFs grew by 50% over the first 3 quarters of the year and sit at record levels. We have also seen a record number of launches so far this year, with 16 coming to market.

That said, representing 20% of the European Sustainable ETF market, fixed income assets still fall short of their 30% market share in the broader European ETF market.

This underdevelopment can be attributed to both the lack of sustainability data for bonds and the challenges of assigning ESG ratings to government debt. While corporate bonds can be scored using a similar ESG scoring system to equities, there are still question marks over how to best evaluate government debt, where there is a fine line between making an objective ESG assessment and straying into political territory.

Taking a stand against the policies of an elected government, even if rationalised from an ESG perspective, is something that individual investors may find easy to do; however, large asset managers or ESG-rating companies' risk being accused of unduly interfering with a political process. ESG assessment of governments is an area that is still a work in progress.

Also, in the case of developed sovereigns, applying ESG filters can lead to outcomes that are difficult to implement. For example, some ESG-conscious investors may consider some of the policies of the former US administration – like the withdrawal from the Paris Climate Agreement – to go against the most basic of ESG principles. One must seriously consider, though, the implications of excluding the largest developed government-bond market in the world from a bond fund.

These difficulties are laid bare, when we consider that at there are just 5 sustainable government bond ETFs listed in Europe with combined assets of only €1.5bn.

TABLE 2. EUROPEAN SUSTAINABLE ETF NET FLOWS

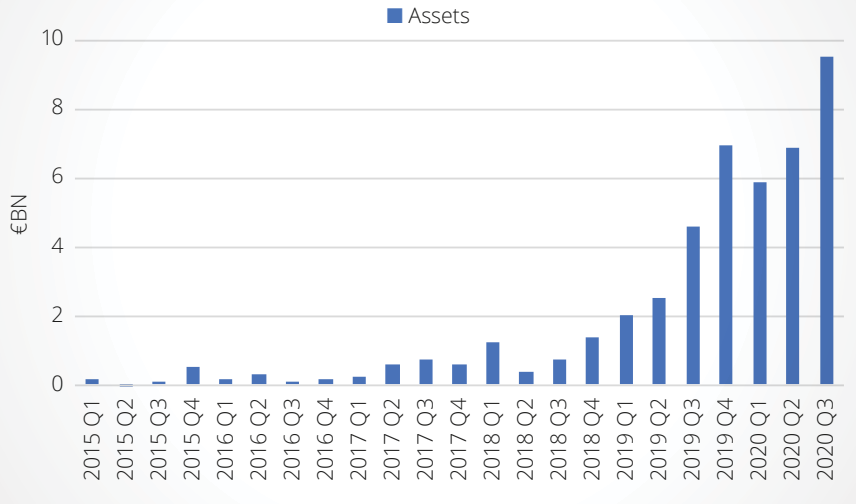


TABLE 3. EUROPEAN CLIMATE AWARE ETF ASSETS

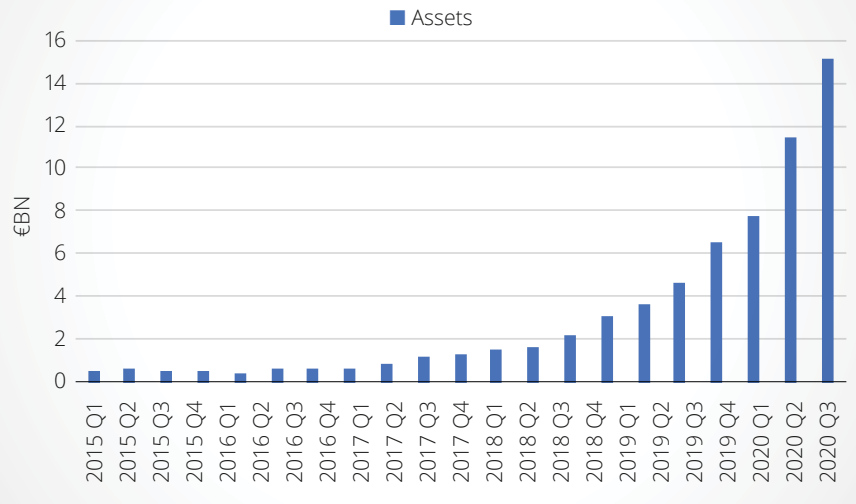
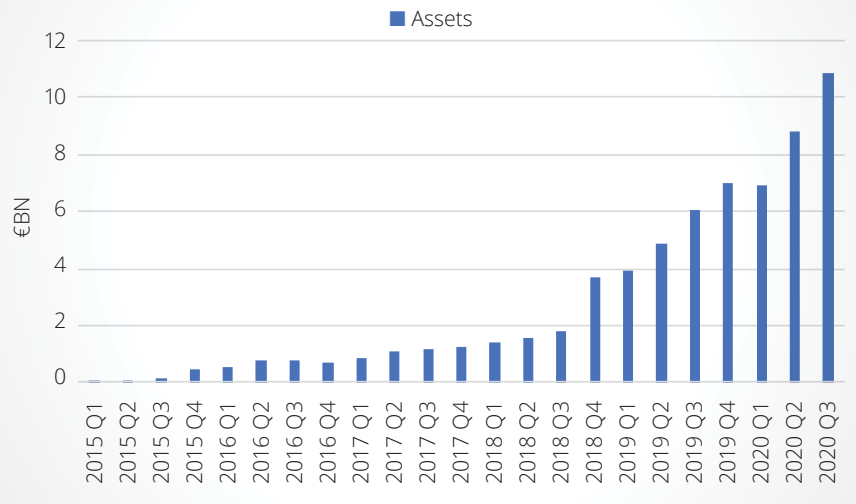


TABLE 4. EUROPEAN SUSTAINABLE FIXED INCOME ETF ASSETS



RETURN TO CONTENTS

60 seconds with the buy-side: What fund researchers look for in factor ETFs

Weixu Yan, head of ETF research at Close Brothers Asset Management (CBAM) speaks to ETF Stream's deputy editor Tom Eckett on balancing high beta exposure such as cyber security and cloud computing with low volatility, how to utilise multi-factor ETFs and why value and growth strategies are not of interest

Do you use smart beta or factor products within your portfolios?

First of all, along with many of my peers, I do not like the term 'smart beta'. It is not very descriptive, and we certainly prefer the term 'factor based indices' or 'factor ETFs'. We use factor ETFs across our range of funds at CBAM. Generally, this is to adjust equity risk exposure of the funds, rather than looking for something to outperform the broad market indices.

How much of your portfolios does smart beta typically make up?

The proportion of factor ETFs invested in the portfolios depends on the market environment, the portfolio composition at the time, and whether the factor ETF actually provides the exposure that we want. Generally, this means they make up around 10-20% of a portfolio. For example, when markets are highly uncertain, there will be take-up of defensive, low volatility ETFs. Sometimes we might have a strong view on a certain factor, but the ETFs available might not provide that exposure; therefore, depending on how closely the ETF tracks the factor we want, we vary the position accordingly. As our funds are well positioned, we are not looking to further increase our allocation to factor ETFs.

How do you view smart beta/factor-based ETFs?

As the range is mainly invested in ETFs and index tracking funds, we view factor-based ETFs as part of the passive toolkit. We utilise them to best express our asset allocation and investment decisions.

Generally, we try to use factors which are intuitive and can be understood by common sense, rather than needing to conduct rigorous statistical testing when the robustness of the factor is doubtful. Complexity does not equal performance; sometimes, simplicity is best

Which parts of the smart beta spectrum interest you most at the moment?

I am currently interested in the low volatility factor. We have increased our allocation to more 'high beta' themes and sectors, like information technology, cyber security, and cloud computing. In order to prevent the funds becoming overly risky, we have combined them with the low volatility factor as a counter balance.

I find value and growth less compelling. In this macro environment they seem to lack clear investment rationale, whereas it is possible to get growth exposure directly from sector or theme ETFs which have clear and specific rationales and exposures.

When you focus on a particular smart beta product to invest in what factors do you take into account?

The most important thing I think about when considering a factor product is the index methodology. The most important aspect is to analyse whether the product provides the exposure that we want; if it does not then we consider whether there is something else that does, and whether we are looking for strong or weak factor strength. To do this, it is vital to conduct thorough research in order to understand how each index is constructed i.e. how the stocks are chosen, weighted, and the frequency of rebalancing.

The fund structure or the wrapper is there to provide tracking to this index – it is often only a secondary consideration. Tracking error is important when there are multiple products to choose from which track the same index, but if there is only one product tracking the index that best fits our investment view then we would rarely discount it solely due to tracking error.

Alongside smart beta, we have also seen the rise of thematic based investing using ETFs. Does this interest you?

Absolutely – thematic investing using ETFs is of great interest. Caution is warranted; thematic ETFs are likely to have little back testing or backing from historical data, while factor investing tends to be based on exactly that.

But just because thematic investing using ETFs does not have as much academic backing, it does not mean it does not work. We are in a very different world post-pandemic and have learnt to always look to the future and use forward looking data to complement the historic data we already have. As such, thematic investing like cyber security and cloud computing resonates quite

well. One way to think of them is 'sector investing 2.0'. However, similar to factor investing, the investor needs to understand the investment thesis; how the stocks are chosen, and thus whether you are getting the exposure you want. There can be even more discrepancy between providers' themes in this space, so research and due diligence are key.

Are you concerned by the recurring accusations of hacking and data mining levelled at all factors and smart beta strategies?

These issues are a concern, and should be to everyone in the industry. Most factors are derived using historical data, and as such are susceptible to data mining. It is now an even bigger issue as algorithms have become more sophisticated and computers efficient, allowing researchers to run multiple calculations simultaneously. When 'new' or claim of 'more robust' factors are presented, it is vital to question that data used and really delve into the details. We prefer simple factors which present fewer data mining opportunities, that work just as well to adjust for equity volatility. The risks grow when trying to find an edge of out-performance.

How do you engage with clients about smart beta? Is there any interest and if there is interest do clients raise any concerns?

Because we use factor ETFs primarily to adjust for equity volatility, we have not seen any client concern around the issue. Generally, we try to use factors which are intuitive and can be understood by common sense, rather than needing to conduct rigorous statistical testing when the robustness of the factor is doubtful. Complexity does not equal performance; sometimes, simplicity is best.

Are there any specific areas where you would like to see new products emerge?

Fixed income is an interesting idea, but due to the return dispersion within the asset class it does not seem to allow as much of slicing and dicing as its equity counterparts.

What I am more interested in are the alternatives or diversifiers from equity and bonds. Of course, this is a small allocation in general and so does not get as much focus from the large ETF providers, but it is a fascinating area for the future.

Does multi-factor investing interest you?

Yes, even more so than the single-factors. This is because I do not believe you can isolate factors in the long-only space. It is better to expect the product to be exposed to multiple factors, rather than believe it is providing isolated single-factor exposure; as an investor, this means you are aware of the unintended factor exposure that you might get exposed to. For example, we have previously invested in a product that provides high dividend and low volatility; as this product provides exposure to more than one factor, I consider it multi-factor.

By 2025 do you think you'll be making extensive use of smart beta products and factor ETFs?

We are already using factor ETFs extensively within the risk parameters and framework set here at CBAM, which is a sensible route that meets our clients' needs. Unless those frameworks change, I imagine we will stick to our current usage.

Weixu worked for Fortune Asset Management which was wholly acquired by Close Brothers Plc in 2010. He now heads up ETF research at Close Brothers Asset Management while managing the Close Tactical Select Conservative, Balanced and Growth Portfolio Funds as well as the Close techMARK fund. His investment universe comprises a full range of passive (Index funds and Exchange Traded Products) investments across the equity, bond and alternative spectrums.

RETURN TO CONTENTS

ESG ETFs dominate market inflows in 2020

ESG ETFs have continued to see significant inflows in 2020 while smart beta ETFs look to finish the year in negative territory, writes George Geddes, senior writer at ETF Stream

ESG ETFs continue to post record inflows month after month this year amid increasing investor interest, more innovative strategies and regulatory tailwinds.

By October's end, Europe-domiciled ESG ETFs recorded €28.3bn inflows year-to-date, representing 90% of all inflows into Europe's equity ETF market nearly 60% of the €48.4bn captured by the whole ecosystem this side of the pond.

Equity ESG ETFs are the most popular among investors compared to fixed income as flows between August and October would suggest. Equity ESG ETFs saw €8.3bn inflows over the course of the three-month period while fixed income ESG ETFs saw a respectable €2.5bn.

The flows are being represented by the types of ESG products that have been coming to market this year with the launches of climate-focused, low carbon and ESG leader ETF ranges all being majority equity strategies.

Smart beta ETFs, however, have not been having a great year as €100m outflows in October meant the ETFs have lost €6bn for 2020 so far.

Some strategies within smart beta have had moments of popularity throughout the year but these bursts of inflows have been rather short lived. Quality ETFs saw roughly €240m inflows in March and April before attention quickly turned to value and quality ETFs across Q2.

Monthly flows	Equity	Fixed income	Total
January	€2.1bn	€200m	€2.3bn
February	€3bn	€500m	€3.5bn
March	€1.3bn	€-300m	€1bn
April	€1bn	€300m	€1.4bn
May	€1.6bn	€800m	€2.4bn
June	€2.8bn	€900m	€3.7bn
July	€2.9bn	€800m	€3.7bn
August	€1.8bn	€800m	€2.6bn
September	€3.2bn	€700m	€3.9bn
October	€3.3bn	€1bn	€4.3bn

Source: Lyxor

In Q3, markets began to recover significantly as lockdown restrictions began to ease across the world. Therefore, investors did make a noticeable shift to momentum ETFs as the factor captured roughly €700m net new assets for the quarter.

As we entered the final quarter, markets did become a bit shaky as lockdowns were gradually being implemented across Europe and there was a high level of uncertainty surrounding the US presidential election. Equal weighted ETFs were the most popular factor in October seeing nearly €200m inflows.

This year is likely to be the first smart beta ETFs in Europe will post negative annual net flows as the strategy has landed between €4bn and €9bn net new assets each year since 2016.