etfexpress

ETF ESG investing

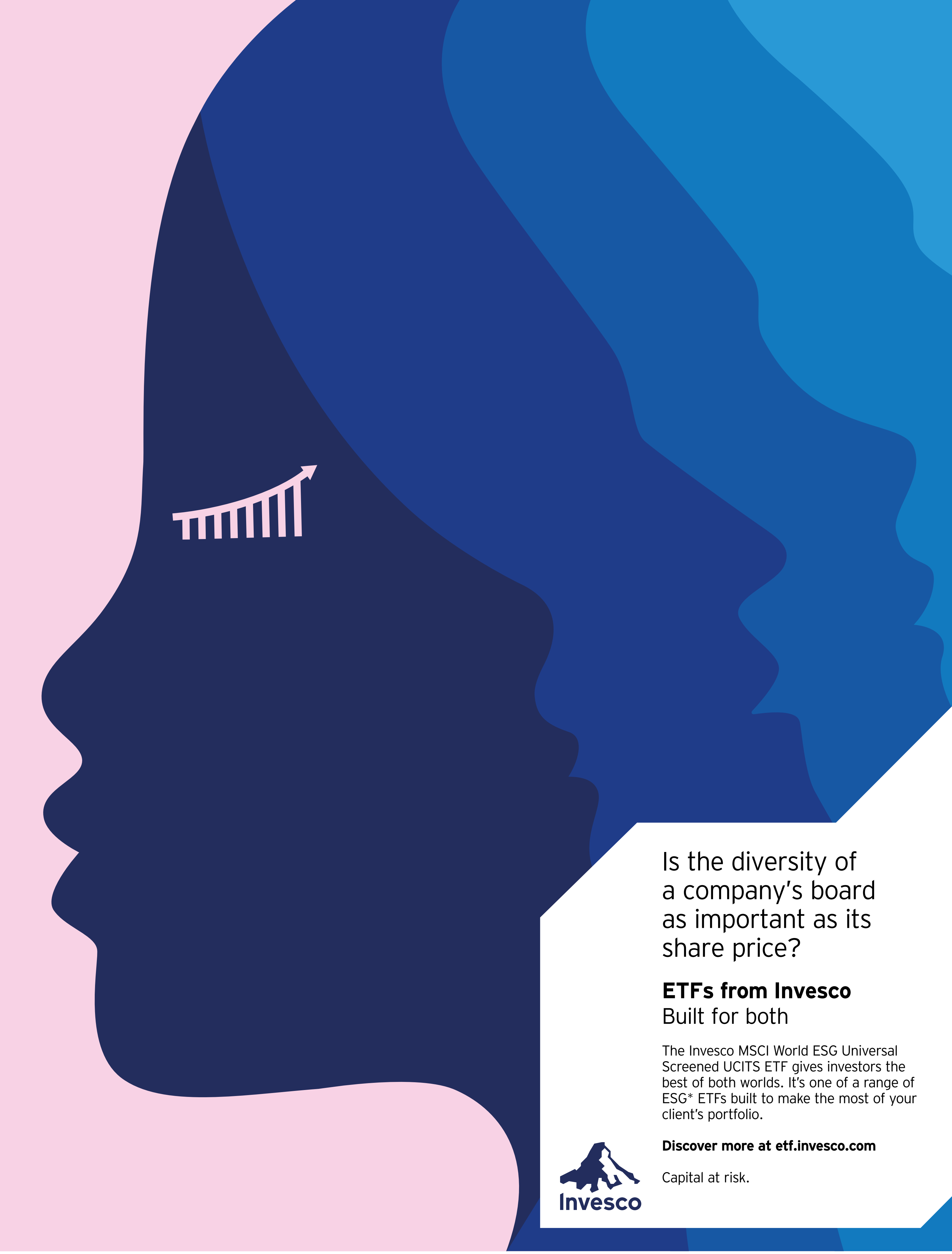
SPECIAL REPORT 2019

EXPECT MORE ESG
Invesco plans more ESG ETF launches

THE BUYSIDE INTERVIEW
Nutmeg details ESG and ETF use

SUSTAINABLE IS HERE TO STAY
iShares combines value and values

Featuring BlackRock | Invesco | Nutmeg


Is the diversity of a company's board as important as its share price?
ETFs from Invesco
Built for both
The Invesco MSCI World ESG Universal Screened UCITS ETF gives investors the best of both worlds. It's one of a range of ESG* ETFs built to make the most of your client's portfolio.
Discover more at etf.invesco.com
Capital at risk.
Invesco

INSIDE THIS ISSUE…

Published by: Global Fund Media Ltd, 8 St James's Square, London SW1Y 4JU, UK
www.globalfundmedia.com

ESG ETFs increasingly meet twin demands of principles and profit

By Beverly Chandler

Environmental, social and governance (ESG) investing has seen enormous growth over recent years with assets pouring into socially responsible investing in all its forms. And, beyond that, new studies show that, where once you had to accept a smaller return for following your principles, now being principled might even enhance your portfolio.

Investing in ESG through the exchange traded fund route (ETFs) has enjoyed a similar ride, with latest data from Morningstar showing that ESG ETFs brought in a record EUR4.3 billion of net new money in the third quarter of 2019, with equity propositions gathering the lion's share. Flows into ESG ETFs represented 17 per cent of the total net inflows for the European ETF market in the third quarter.

Over at data providers ETFGI, a similar story unfolded with data showing that ETFs and ETPs invested in ESG globally gathered net inflows of USD2.80 billion during September.

Total assets invested in ESG ETFs and ETPs increased by 7.81 per cent from USD43.90 billion at the end of August to a record USD47.33 billion, according to ETFGI, with Europe dominating with the most ESG classified products available, followed by the US and the Asia Pacific region excluding Japan.

A recent study from Lyxor offers us evidence that ESG investors do not have to compromise on performance. A positive screening strategy based on ESG scores can raise the ESG profile of portfolios, without denting returns, the firm says.

Lyxor's figures show sustainable investment assets, including both actively and passively managed ESG funds, reached more than USD31 trillion at the end of 2018, up 34 per cent since 2016. This now represents a 39 per cent share of global professionally managed assets, Lyxor reports.

Their study was conducted in association with the Lyxor Dauphine Research Academy, as well as their in-house research team. Researchers Fabio Alessandrini and Eric Jondeau of the University of Lausanne, found that, based on an analysis of the past performance of a universe of stocks (represented by the MSCI All Country World index) during the period 2007-2018, a policy of exclusion based on companies' ESG scores did not impact portfolio performance negatively.

The researchers also found that in most cases, using an ESG filter improved the performance of risk factor portfolios, even on a risk-adjusted basis. For example, excluding 50 per cent of firms with the lowest ESG ratings from a European equity size portfolio added 2.3 per cent per annum of return over 10 years, while removing 1.6 per cent of volatility.

And although the bulk of ESG assets are still actively managed, there's evidence of a shift to index funds amongst ESG investors, Lyxor says. In Europe, for example, passive ESG fund assets have grown at a rate of 35 per cent per annum over the past five years, compared with 11 per cent for actively managed ESG funds.

More research from the French on the ESG and ETF subject comes from Lyxor's parent bank Societe Generale. Their report 'Shades of green – A review of Socially Responsible Investment (SRI) ETFs and 50 underlying benchmarks' found that some SRI ETFs could be good options to replace traditional world, emerging market and Eurozone ETFs. However, by contrast, classic US equity ETFs remain more efficient than their SRI rivals.

The SocGen study found that excluding Impact Investing, Thematics ETFs and Factor ETFs, there are 90 different products available in the US and Europe in the SRI space, equating to 13.5 per cent of the long-only country/region equity ETF offer, cumulating at around USD26 billion in assets under management in aggregate at mid-August 2019.

The report notes that SRI has gained considerable traction in recent years, with an increasing number of investors motivated by non-wealth factors without sacrificing financial returns.

"Against this backdrop, the question of reconciling financial performance and corporate social responsibility have taken centre stage," the report says.

Based on current ESG scores and ratings, most recent studies demonstrate that ESG is not yet a factor. Better ESG scores could change this picture in the future but, for now, ESG cannot be considered as a source of additional risk or performance, says Societe Generale.

"But nor can it be considered as hurting risk-adjusted returns. For this reason, it is possible to turn a traditional strategy into an SRI-oriented strategy at no additional cost. This has led to the creation of hundreds of SRI indices in the passive management space."

SocGen found that some SRI ETFs offer higher risk-adjusted returns than traditional ETFs, together with competitive holding costs.

The investors searching for all this ESG filtered investment are varied across the whole range of investors but millennials are the major driver in the wealth sector. Interviewed for this report, Chris Mellor, Head of Equity and Commodity ETF Product Management, Invesco, comments on what he calls a societal change in investor approach to investing, driven by a recognition of the work of climate change activist Greta Thunberg, while others in the industry cite the impact of Blue Planet II, showing the physical effects of plastic pollution on the natural world.

Robo-Adviser Nutmeg's offering in the ESG space reflects the changing nature of the investor as well. James McManus of Nutmeg says that both their client base and their staff wanted socially responsible investment, commenting that their clients wanted an investment in line with their personal values, just as they choose organic or free-range produce in a supermarket, they wanted the same thing in their investment choices. The result for Nutmeg, which invests entirely through ETFs, is over 8,000 socially responsible investment portfolios, with combined assets over GBP120 million, while McManus reveals that a fifth of new investments from our clients in 2019 have been into the socially responsible portfolios.

The conclusion is clear. ETF investors want ETFs which offer an ESG approach. ■

Watch this space for more ESG launches from Invesco

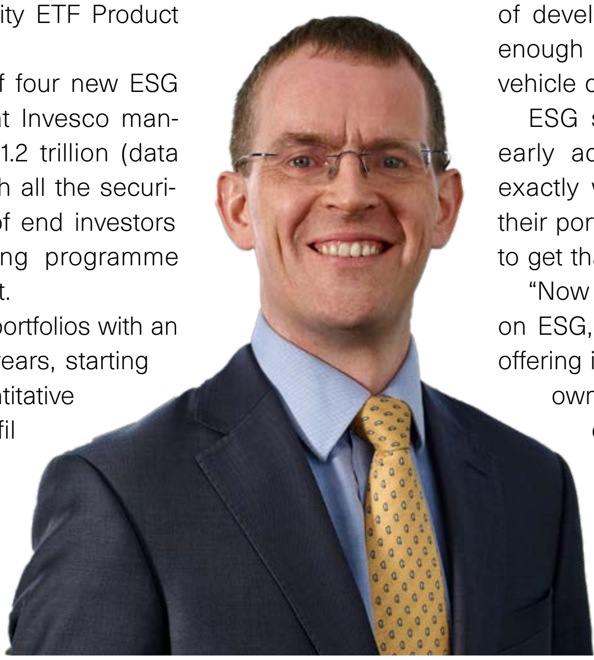
Interview with Chris Mellor

Environmental, social and governance (ESG) principles are integrated throughout Invesco says Chris Mellor, Head of Equity and Commodity ETF Product Management, Invesco.

The firm's recent launch of four new ESG products mirrors the way that Invesco manages its total assets of USD1.2 trillion (data as at 30 September 2019), with all the securities they manage on behalf of end investors included in their proxy voting programme which has an ESG component.

The firm has been running portfolios with an ESG focus for more than 30 years, starting with portfolios run by the quantitative team out of Frankfurt to fulfil mandates for clients looking for specific ESG criteria.

The main driver behind launching the ESG ETFs was customer demand. Mellor says: "We have been getting more and more questions from clients and more enquiries as to what we have in that space, and now we are at a point in terms of development in ESG usage that there is enough demand from investors that a pooled vehicle could actually work effectively."



ESG started out as an area of focus for early adopters who had strong views on exactly what they wanted or didn't want in their portfolios, and they would use mandates to get that, Mellor says.

"Now more investors have a bigger focus on ESG, and the focus is not just on people offering investment products but also on asset owners who ultimately make the decision of where to invest."

The pull is societal, Mellor says. "Greta Thunberg is obviously a recent catalyst for movement around climate change and more and more youngsters are coming from the mind set where they are less clear cut or stark on specific definitions of ESG compared with the early adopters. So, there is a coalescence around what is or isn't acceptable and what are good ways to integrate ESG in a portfolio."

Mellor explains that ESG ETFs generally come from two different positions. One group, such as the MSCI ESG Universal indices, offers core beta replacement for investors' portfolios. While another group is what Mellor calls a 'darker green' with stronger ESG constraints and exposures.

"There are lots of investors out there who are relatively new to ESG and still need to think in terms of benchmarks and performance, so they have a tug of war going on with the desire to include ESG criteria but the problem of accepting the bigger tracking error from the benchmark that this potentially produces," Mellor says.

The MSCI SRI indices for example, are a 'darker green' option leading to tracking errors of up to 1.8 per cent, Mellor says. "It's quite a lot of benchmark risk to be taking. When we looked at the area there was nothing for the investor who wants to add ESG but doesn't want to take too many off-benchmark bets."

The MSCI Universal indices offer a "lighter green" approach, using ESG scoring and ESG score momentum to adjust the weights of the stocks in the portfolio. The standard version of these indices also filter out companies which have been involved in severe controversies and those which make controversial weapons.

"The problem for this standard approach is that you could still own companies involved in some ethically difficult areas such as tobacco or weapons, so fund providers can add exclusions to the indices that most investors would agree on: removing all types of weapons, tobacco, thermal coal and oil sands."

"This approach has outperformed slightly over the back-tested periods," Mellor says. "However, these ESG products aren't designed to outperform but to give you an efficient ESG exposure. That said, there is in my view good evidence out there now that suggests a positive link between ESG momentum and performance."

Effectively, the ESG filters help an investor avoid company specific risk or risk that wouldn't be picked up by other factors. Mellor cites the fact that the MSCI ESG score was low for BP before the company had the Deepwater Horizon oil spill, or for Volkswagen, which had a low ESG score prior to its emissions' scandal.

"If you run the numbers across a more statistically relevant sample, as the researchers have, they typically find evidence of outperformance from ESG portfolios," Mellor says.

Mellor reports that feedback from investors on Invesco's ESG range has been very positive. "Most investors have ESG on their radar, the degree of inclusion depends on where in the world you go," he says. "Travelling around Europe, you find that ESG is firmly embedded in most investor approaches in Scandinavia and the Netherlands these days. They have an understanding of why we launched this."

Mellor confirms that the plans are to expand the core beta ESG exposure and to add more ESG products in the space with a "darker green" tint. "Ultimately our aim is to provide products that meet our clients' needs and ESG products fit one portion of the portfolio – there are other areas we are looking to address in the near future as well. Definitely watch this space." ■

Chris Mellor
Head of EMEA ETF Equity & Commodity Product Management, Invesco

Chris Mellor leads the EMEA ETF equity and commodity product management team at Invesco, responsible for providing support and analysis for the range of equity and commodity ETFs. Before joining Invesco he worked as an investment strategist, focusing on market timing and tactical allocation across regions, sectors and styles for Sunrise, State Street Global Markets, Credit Suisse and Societe Generale. Chris holds a Doctor of Philosophy in Inorganic Chemistry from Balliol College, Oxford. He is also a charterholder of the CFA Institute.

The buyside interview

James McManus, Director of ETF Research at Nutmeg, explains how his firm uses ESG and ETFs within its portfolios

What was the driver for launching the ESG offering at Nutmeg?

We knew from customer feedback – and the feedback of our own staff who are themselves users of the Nutmeg service – that there was demand for a socially responsible investment style. Our clients had expressed a clear preference to invest in-line with their personal values. They could often understand how their values align to other areas of their life, for example how sustainable their energy provider was, or whether the produce they purchase in the supermarket was free range or organic. However, they didn't feel they had this same clarity when it came to their investment choices.

The problem was that there were very few pragmatic approaches available in the marketplace that were suitable for a broad range of retail investment goals, and transparent about their outcomes. Separately to this, we were also exploring the integration of ESG factors into our wider investment process and had formed a view on the importance of doing so. So, we set out to combine our investment expertise with industry leading ESG insights to offer investors the best possible current access to ESG themes, while ensuring they remained on track to their investment goals.

How big has it got?

A year after launching them, Nutmeg manages more than 8,000 socially responsible investment portfolios, with combined assets over GBP120 million. A fifth of new investments from our clients in 2019 have been into the socially responsible portfolios. For reference, we currently have more than 75,000 customers in the UK.

Who is using it?

Socially responsible portfolios are available across our product offering, from stocks and shares ISAs to pensions. Nutmeg is used by retail, mass affluent and high-net-worth investors to help them achieve their financial goals, so we have a broad spectrum of clients.

The average age of an investor in a socially responsible pot is two years younger than the broader base at 37, compared with 39, and socially responsible investors are more likely to be female than the base a whole – 39 per cent compared to 35 per cent. We have found interest in this investment style from across our client base.

How do you add the ESG element to your offering?

At Nutmeg, we're using the term socially responsible investing, as we believe this term fairly reflects our customers' interests in limiting exposure to companies that engage in controversial activities while increasing exposure to companies that lead their peers in social responsibility. Core to our approach was to ensure that our SRI portfolios retained the core features present in existing Nutmeg portfolios: a focus on diversification, global asset allocation, low costs and daily liquidity.

Broadly speaking, we retain an active asset allocation approach, and execute our investments using exchange-traded funds (ETFs) to maximise diversification. We use strategies that screen for controversies or industries deemed to have a high social or environmental impact, while positively weighting towards those companies and bond issuers undertaking business in a progressive way relative to peers.

Many of these strategies use MSCI indices, and so we have embedded MSCI's ESG Manager platform into our investment process to deliver deep insight into strategy attributes, allowing us to effectively blend strategies within one approach.

How seriously do you take identifying ESG filters through your portfolios?

We take it very seriously. We became a signatory of the Principles for Responsible Investment in 2018 to make a public commitment to responsible investment practices (we were one of only a handful of UK wealth managers to do so).

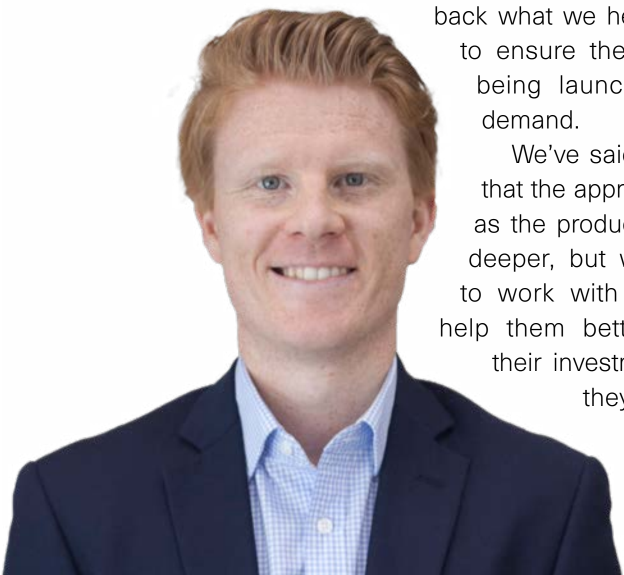
We believe that the core investment portfolio of the future will be one that considers ESG as central to its investment process. We also believe it will be incumbent on investment managers to report against ESG metrics. We have led the way here with the incorporation of ESG metrics into reporting for all of our investment portfolios.

One widely held criticism of many ESG focused investment portfolios is the lack of qualification for their credentials. They typically do little to qualify to investors how they compare against traditional portfolios, meaning investors have little knowledge as to the true difference, or what trade-offs have been made along the way. We believe our customers deserve to know where their investment portfolios stand when it comes to ESG factors. That's why we score all of our portfolios, SRI and non-SRI, against a range of ESG factors, using data from MSCI to empower our customers' decision making. For example, you can see how your portfolio stacks up against a range of ESG issues, such as carbon intensity or board diversity.

Any plans to develop this further?

Nutmeg is an acknowledged expert in the exchange-traded fund (ETF) market, so we hope to continue using our influence as an investor to engage with ETF providers on corporate governance and index suitability and selection in the market for sustainable and ESG funds. We also want to play a critical role on product development, feeding back what we hear from clients to ensure the ETF products being launched meet this demand.

We've said from the start that the approach will evolve as the product set becomes deeper, but we also intend to work with our clients to help them better understand their investments and how they align to their values. ■



James McManus
Director of ETF Research, Nutmeg

Sustainable investing is here to stay

Armit Bhambra, Head of iShares UK Retirement at BlackRock, writes that sustainable investing was once viewed as a trade-off between value and 'values'

Yet today, it's something investors can no longer afford to ignore. What has changed? More granular data, more sophisticated analysis and shifting societal understanding of sustainability, as well as growing awareness that certain factors – often characterised as environmental, social and governance (ESG) – can be tied to a company's long-term growth potential.

Regardless of investor views, ESG is increasingly on the agenda – especially for UK trustees who, from October 2019, will be required to show more formally how they have taken ESG into consideration. The Department for Work and Pensions statement of investment principles requires clear indications on how ESG and investment stewardship factors are considered within investment arrangements. These are 'Financially material (ESG) considerations' over the appropriate time horizon for investment; 'Non-financially material' ESG considerations, if trustee boards have any; A statement on engagement activities.

This new requirement has varying levels of engagement from different schemes. This may be partly due to differing circumstances, but also the range of attitudes in the sector towards what can be a controversial subject. One point worth stressing, however, is that there is an increasing tendency to take more informed views on this area, and this focus will steadily increase as more and more reliable data becomes accessible to investors. Access to good quality information on prospective investments at worst does not change your investment thesis and, at best, it transforms an investor's view. Taking this into account is a key part of the process for pension scheme arrangements.

BlackRock defines ESG integration as the practice of explicitly incorporating environmental, social and governance information into investment decisions to help enhance risk-adjusted returns.

As a result, we have launched a firm-wide, global effort to integrate sustainability considerations into the investment process. This mirrors the diversity of clients we serve, as well as the range of investment strategies and asset classes we offer. Across BlackRock, we provide all our investment teams with data and insights to keep them well-informed of sustainability considerations.

This leads to our interest in offering sustainable solutions that allow our clients to attain their financial objectives. The range of sustainable investing options is broad, reaching all the way from green bonds to renewable energy infrastructure. Furthermore, BlackRock is the largest provider of sustainable ETFs, including the largest low-carbon ETF in the market. ETFs are a great choice to navigate this new sustainable environment, for three main reasons.

First, they offer a minimal tracking error, being a relevant substitute for those products that track traditional indices. Second, they have a low cost and are an easy way for schemes to show their ESG involvement without having to invest all their time into this trend, which is here to stay. Finally, ETFs allow investors the opportunity to invest in a wide range of products, with varied exposure to the amount of sustainability they are willing to get involved in.

However, even though the proliferation of ESG options is good, it is important to understand what you are looking at. The BlackRock iShares ESG ETF range can be divided into five areas, which start from avoiding exposures that conflict with your social objectives, all the way to target outcomes that advance your social and financial objectives:

- **ESG Screened Range:** this eliminates exposures to companies or activities that pose certain risks, or which violate an investor's values. It is designed for investors looking to screen out controversial business areas while maintaining a profile similar to traditional benchmarks.

- **ESG Enhanced Range:** the objective is to maximise ESG scores (calculated and provided by MSCI), subject to a target tracking error. It is designed for those investors building sustain- able portfolios.
- **SRI Range:** a socially responsible investment (SRI) approach is used to gain exposure to the top ESG performers in each sector. It is designed for those investors with the highest commitment to, and conviction towards, the top ESG performers.
- **Thematic Investing:** this type of investing focuses on an ESG trend, allowing investors access to structural economic themes such as low carbon, clean energy or inclusion and diversity.
- **Impact Investing:** this approach focuses on generating a measurable sustainable outcome alongside a financial return. It is designed for long-term investors looking to drive measurable change.

ESG data has evolved. New technologies and methodologies have allowed us to make great strides in improving sustainability data, as can be seen from the wide range of options that ESG ETFs have to offer. Our research, which relies on back-tested data, shows how ESG-focused indices have matched or exceeded returns of their standard counterparts, with comparable volatility.

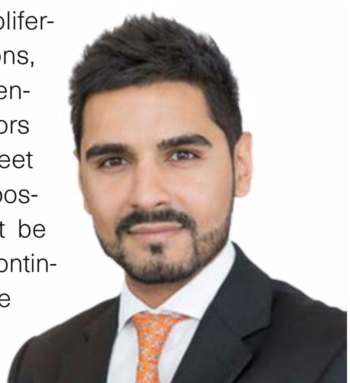
We find ESG has much in common with existing quality metrics such as strong balance sheets, suggesting ESG-friendly portfolios could be more resilient in downturns. This suggests that ESG is not just a box-ticking exercise, to be performed by schemes to satisfy the criteria of new regulations. It can enhance returns and ETFs offer a cost- efficient and operationally efficient way to get exposure to this theme.

In the UK, we have seen that, ahead of new regulations, local authorities have been shifting their index allocations into low-carbon alternatives. The shift in other regions, such as the Nordic or Benelux countries, has been remarkable over the last few years, forcing investors to include ESG into their investment processes. Regulation and social awareness have been key to the growth of this type of investment. We saw this with one of the largest private pension insurance companies in the Nordic region.

BlackRock worked in close collaboration with the client to create a core sustainable solution for its US equity allocation, which was a part of a broader integration of ESG characteristics within the investment strategy. This case is a testament to the transformation we are seeing in the Nordic region, with institutional investors shifting their portfolios from standard to sustainable benchmarks, and it highlights the importance of collaborating with clients to build solutions that meet their criteria.

Assets in dedicated sustainable investing strategies around the world have grown at a rapid clip, driven by societal and demographic changes, regulation and increased investment conviction. Incorporating relevant sustainability insights can provide a more holistic view of the risks and opportunities associated with a given investment. There is no one-size-fits-all approach, but the opportunity to improve investment processes by integrating material sustainability considerations is real and growing.

To that end, a perfect storm is brewing, that will mean ESG climbs towards the top of the agenda for European pension funds and consultants. Between a changing regulatory environment, improving data and a proliferation of investable products and solutions, the scene is now set for European pension funds to become significant investors in investment strategies that help meet their liabilities, as well as delivering a positive societal outcome. The road won't be smooth, nor will it be immediate, but a continuing increase in ESG investing across the sector is becoming irrefutable. ■



Armit Bhambra
Head of iShares UK Retirement, BlackRock

Armit Bhambra, Director, is head of UK Retirement for iShares EMEA. In this role, Armit is responsible for developing relationships with Pension Funds to elevate the conversation on ETF usage. Working with Investment Consultants, Defined Benefit Schemes and Defined Contribution Schemes, Armit has been in his current role for five years.

Prior to joining BlackRock, Armit worked as an investment consultant at KPMG designing investment strategy for European Pension Funds. At KPMG, Armit implemented private and public market mandates, designed a number of LDI programs and put into place CDI strategies. Armit is passionate about global retirement markets and being part of the solution that solves for the challenges in that market. Armit is a Chartered Alternative Investment Analyst, holds the Investment Management Certificate and the Investment Diploma from the Chartered Institute for Securities and Investments.

ABOUT iSHARES

iShares unlocks opportunity across markets to meet the evolving needs of investors. With more than twenty years of experience, a global line-up of 900+ exchange traded funds (ETFs) and $2 trillion in assets under management as of September 30, 2019, iShares continues to drive progress for the financial industry. iShares funds are powered by the expert portfolio and risk management of BlackRock, trusted to manage more money than any other investment firm (based on $6.96 trillion in AUM as of 9/30/19).

www.ishares.com

ABOUT INVESCO

Invesco is an independent investment management firm dedicated to delivering an investment experience that helps people get more out of life. We are privileged to manage $1,184.4 billion in assets on behalf of clients worldwide (as of September 30, 2019). We have:

- Specialised investment teams managing investments across a comprehensive range of asset classes, investment styles and geographies.
- Over 8,000 employees focused on client needs across the globe.
- Proximity to our clients with an on-the-ground presence in 25 countries.
- Solid financials, an investment grade debt rating, and a strong balance sheet.

Contact: ETF Distribution Team | +44 (0)20 8538 4900

www.invesco.co.uk